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IN THE

Supreme Court of the United States

OCTOBER TERM 1968

No. 897

FRANCIS G. COATES,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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January 3, 1969

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SECURITIES AND EXCHANGE COMMISSION,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Company, et al.*, entered on August 13, 1968.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 401 F. 2d 833 and is printed as Appendix A hereto. The opinion of the United States District Court for the Southern District of New York is reported at 258 F. Supp. 262 and is printed as Appendix B hereto.

JURISDICTION

The judgment of the Court of Appeals was entered on August 13, 1968 and is printed as Appendix C hereto. Petitioner filed a petition for rehearing on September 20, 1968. That petition was denied on October 7, 1968. The jurisdiction of this Court is invoked pursuant to 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED

1. Does a director's purchase of stock on a national securities exchange on information which has been publicly announced at a news conference constitute fraud or deceit under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder?

2. Does a director's purchase of stock on a national securities exchange on information which he believes to be available to the public, constitute fraud or deceit under Section 10(b) and Rule 10b-5?

3. Is a director guilty of fraud or deceit for failing to comply with a standard of conduct proposed for the first time in the complaint herein?

4. Does Rule 10b-5, as construed by the Securities and Exchange Commission and the Court below, provide the ascertainable standard of conduct required by the Fifth Amendment to the United States Constitution?

CONSTITUTIONAL PROVISION, STATUTE AND RULE INVOLVED

Fifth Amendment to the Constitution of the United States:

> "No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

Securities Exchange Act of 1934, § 10(b), 48 Stat. 891, 15 U. S. C. § 78j:

> "Sec. 10. Regulation of the Use of Manipulative and Deceptive Devices
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> ". . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regu-

lations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 C. F. R. § 240.10b-5: "Employment of manipulative and deceptive devices":

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

STATEMENT OF THE CASE

The Proceedings Below

This is an action by the Securities and Exchange Commission (the Commission) against the Texas Gulf Sulphur Company (Texas Gulf) and certain of its directors, officers and employees, charging them with fraud

and deceit in violation of Section 10(b) of the Securities Exchange Act of 1934 (the Act) and Rule 10b-5 promulgated thereunder (R. 2851-85).* Trial proceeded without a jury on the issue of whether defendants violated Section 10(b) and Rule 10b-5, the Court reserving the issue of remedy for later hearing (App. B, 1). The District Court exonerated Coates, who at all times relevant herein was a director of Texas Gulf, holding that his purchases of Texas Gulf stock did not constitute a device, scheme, or artifice to defraud or an act which operates or would operate as a fraud or deceit upon any person within the meaning of Section 10(b) and Rule 10b-5 (App. B, 41-44). The Court of Appeals reversed (App. A, 3595).

The Commission's Charges

This action arises out of Texas Gulf's exploratory activities near Timmins, Ontario, in late 1963 and early 1964. The first exploratory drill hole was completed on November 12, 1963 and further exploratory activities proceeded thereafter. At a news conference held in New York City on April 16, 1964, Texas Gulf announced the existence of a major discovery at Timmins (App. A, 3596-3604).

The complaint charges Texas Gulf with issuing a misleading press release on April 12, 1964, regarding its Timmins exploratory activities. The individual defendants are charged with fraud and deceit by reason of purchasing, advising others to purchase or accepting options from Texas Gulf to purchase shares of Texas Gulf stock at varying dates from November 12, 1963, to the close of business on April 16, 1964. Coates and Lamont (who is since deceased and not a party to the appeal below) were

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*The Record on Appeal is cited "R. ——". The Appendices to this Petition are cited as "App. —— ".

the only defendants charged with violating Section 10(b) and Rule 10b-5 by reason of purchasing Texas Gulf stock or allegedly advising others to purchase it after the conclusion of Texas Gulf's April 16 New York press conference (R. 2851-85; App. A, 3593 fn. 6).

The Commission's charges against Coates are predicated solely upon the fact that after the conclusion of the April 16 press conference he telephoned his broker (who is also his son-in-law) and ordered 2,000 shares of Texas Gulf stock to increase the holdings of that stock by several family trusts. The Commission charged that Coates thereby violated Rule 10b-5 and that his violation encompased not only his purchase of 2,000 shares but also included purchases made by his broker for other accounts on both the morning and afternoon of April 16 (R. 2879-81).

The Facts Relating to Coates

Coates telephoned his broker only after the following sequence of events:

(1) On April 12, following wide press coverage of rumors of the Timmins discovery, Texas Gulf announced that a release would be forthcoming about the Timmins project* (R. 1132-37, 1149-51, 1224-27, 2874-75).

(2) Coates, a senior member of the Houston law firm of Baker, Botts, Shepherd & Coates and a director of long service of Texas Gulf, first learned of the Timmins project from the *Wall Street Journal* of April 13 which carried the Company's April 12 release (R. 132-33, 176, 144-46, 1256).

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*The April 12 release stated in part:
"When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project." (R. 2874-75)

(3) Coates arrived in New York on April 15 from his home in Houston to attend a regularly scheduled meeting of the Texas Gulf Board of Directors on April 16 (R. 145-46). On arrival, he went to the Company's offices and while there read a draft of the announcement of a "major discovery" then being prepared for release at a news conference which had been called for 10:00 a. m. on the following day (R. 146-47). Coates was told on April 15 that the Minister of Mines of the Province of Ontario would make an announcement of the Timmins discovery at 11:00 p. m. that night and understood that the announcement would be made on radio and television (R. 147). Coates also saw a list of the persons invited to the New York news conference (R. 147-48).

(4) Coates, who had for some time contemplated adding to his holdings of Texas Gulf stock, had by then decided to buy additional shares but to wait to do so until after the scheduled news conference (R. 151-52, 155-59, 172-73).

(5) On the morning of April 16, the *Northern Miner,* a widely circulated and respected Canadian mining publication, carried an officially sanctioned banner story concerning the Timmins discovery (App. B, 34-35; R. 993-99, 2183-84, 2228-30). Information from the *Northern Miner* article was relayed to brokers in New York prior to the opening of the New York Stock Exchange on April 16 (App. B, 35; R. 2180-2207, 2230-31, 2277-91, 2342-52, *inter alia*). From that and other sources, news of the Company's confirmation of the ore strike was known throughout the financial community prior to the opening of the market on April 16,

with the result that trading on the opening of the market was "wild" (R. 2277-91, 2355-62, 2521-27).

(6) At the Board of Directors' meeting at 9:00 a. m. on April 16, the President of the Company stated that the announcement by the Minister of Mines had been made in Toronto the preceding night (R. 1207-11, 1270). The announcement was in fact not made until 9:40 a. m. on April 16, but the error was not discovered or conveyed to Coates for some days after April 16 (R. 163-65, 1005-08, 1210-11, 1270).

(7) At the news conference at 10:00 a. m. on April 16, the representative of the Dow Jones Instant News Service was present, along with other reporters and representatives of brokerage houses (App. A, 3603; R. 2446-50, 202-04, 1266-69). Stephens, the President of the Company, announced that "Texas Gulf Sulphur Company has made a major strike of zinc, copper and sulphur in the Timmins area of Ontario, Canada", and read further from the prepared text which had been handed to the reporters and brokers' representatives (App. B, 40; R. 90, 2451). Some reporters left upon the first sentence, others stayed until the end (R. 165, 205, 2388, 2423). The Dow Jones representative was among the first to leave and telephoned the news for instant dissemination in a series of three "takes", the first of which, announcing the existence of a confirmed mine, should have appeared in every brokerage house within two or three minutes (R. 2450-54). (For unexplained reasons, there was in fact a delay of some 45 minutes before the news appeared on the broad tape at 10.54 a.m. (App. A, 3619, fn. 19)).

It was only after the news conference ended that Coates telephoned his broker to place an order and told him that there had been a public announcement of the Timmins discovery (R. 151-52, 160-62). At the time he telephoned his broker Coates believed that the announcement had already appeared on the Dow Jones broad tape (R. 166).

The Opinions Below

The District Court

The District Court dismissed the complaint as to Coates holding that the evidence established that Coates telephoned his broker only after the New York press conference concluded and that his purchases did not constitute a device, scheme, or artifice to defraud or an act which operates or would operate as a fraud or deceit upon any person within the meaning of Section 10(b) or Rule 10b-5 (App. B, 41-44).

The District Court held that it was not fraud or deceit for a director to purchase shares on the basis of material information once that information has been announced, stating that it is the "generally accepted rule that it is the making of the announcement that controls." (App. B, 42) The District Court rejected the Commission's argument that the Court should fix a reasonable waiting period after an announcement is made, during which insiders cannot purchase, noting that "the Commission has not supplied, nor has the Court found, decisions specifying a waiting period after a corporate announcement is made." (App. B, 44). The Court stated that "if a waiting period is to be fixed, this could be most appropriately done by the Commission, which was established by Congress with broad rule-making powers." (App. B, 44).

The Court of Appeals

The Court of Appeals reversed the District Court holding that Coates' telephone call to his broker after the press conference concluded constituted fraud and deceit in violation of Section 10(b) and Rule 10b-5. The Court stated that "at the minimum Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape . . ." (App. A, 3618-19). The Court noted that Coates honestly believed that the news had been disseminated when he telephoned his broker but held that Coates' belief was not a defense to a charge of fraud and deceit because, in the Court's view of the evidence, it was not reasonable to anticipate that the news would appear on the broad tape until 10:22 a.m (App. A, 3619 fn. 20, 3622)—two minutes after Coates placed his order.

REASONS FOR GRANTING THE WRIT

The Court of Appeals decided incorrectly questions of federal law which are of great importance to all corporate officers, directors and employees. Those questions have not been and should be decided by this Court.*

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*The judgment of the Court of Appeals, although interlocutory, is appropriate for review because it involves important and clearly defined issues of law fundamental to the further conduct of the case. See *J. I. Case Co.* v. *Borak*, 377 U. S. 426 (1964); *Land* v. *Dollar*, 330 U. S. 731 (1947); *United States* v. *General Motors Corp.*, 323 U. S. 373 (1945).

The unprecedented publicity given to the Court of Appeals' decision in this case and to comments thereon is an indication of the importance of and widespread interest in the issues presented herein. See, *e.g.*, *N. Y. Times*, Aug. 28, 1968, p. 46, Sept. 12, 1968, p. 71, Oct. 13, 1968, § 3, p. 1; *Wall St. Journal*, Aug. 29, 1968, p. 24. In October 1968, more than 1,000 persons attended a two-day seminar sponsored by the Practising Law Institute in New York on the

I

IT IS NOT FRAUD OR DECEIT FOR A DIRECTOR TO PURCHASE STOCK ON INFORMATION WHICH HAS BEEN PUBLICLY ANNOUNCED AT A NEWS CONFERENCE.

(a) Section 10(b) and Rule 10b-5 do not prohibit the use of inside information in the absence of fraud or deceit.

The Court below construed Section 10(b) and Rule 10b-5 as if they circumscribe a director's use of inside information even if such use is neither fraudulent nor deceitful. In that construction, the Court below ignored (a) the clear language of the Statute and Rule and (b) the legislative history of Section 10(b).

Rule 10b-5, so far as relevant here, makes unlawful "any device, scheme or artifice to defraud" and "any act, practice or course of business which operates or would operate as a fraud or deceit upon any person".*

In applying the Rule to transactions by insiders, the Court below made no attempt to track the language of the Rule or to demonstrate by analysis how petitioner's acts

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Texas Gulf Sulphur decision. The Director of the Institute described that seminar as "the greatest turnout ever in the entire field of corporate law". Richard V. Bandler, Associate Regional Administrator of the Commission in New York was quoted by the *New York Times* as saying that attendance at the seminar was "certainly . . . an indication of great confusion and wide interest." *N. Y. Times*, Oct. 13, 1968, § 3, p. 1.

*The only duty of disclosure created by Rule 10b-5 is contained in subdivision 2, which makes it unlawful "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." That subdivision has no applicability to the charges against Coates since he concededly made no statements in connection with his purchase. Apart from that subdivision, Rule 10b-5 does not deal with non-disclosure except to the extent that non-disclosure might constitute fraud or deceit, *i.e.*, if special circumstances created a duty to disclose so that silence would be misleading.

came within the Rule's prohibition against fraud. Rather, the Court stated merely (App. A, 3606):

> ". . . The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public. *Matter of Cady, Roberts & Co.*, 40 SEC 907, 912 (1961) . . ."*

In other words, the Court interpreted Rule 10b-5 not as a rule prohibiting acts which would operate as a fraud or deceit but as a rule of "fair conduct" in trading by insiders. The absence of analysis is understandable since there is no logical basis for concluding that the mere placing by an insider of an order to *buy* stock on the New York Stock Exchange could have induced any owner of Texas Gulf stock to *sell*. By contrast, in determining whether Texas Gulf's April 12 press release was issued "in connection with the purchase or sale of any security" as that phrase was used in Section 10(b), the Court below stated that the acts which Congress intended to prohibit were those "of a sort that would cause reasonable investors to rely thereon" and thus "cause them to purchase or sell a corporation's securities." (App. A, 3630) It is beyond cavil that the mere placing by an insider of an order to buy stock on a securities exchange would not cause an investor

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*The *Cady, Roberts* opinion was written by the Commission as part of a stipulated settlement and was, of course, not subject to judicial review.

to rely thereon and thus purchase or sell securities and is not an act which Congress intended to prohibit by Section 10(b).

In enacting the Securities Exchange Act of 1934, Congress was fully aware of the problems involved in stock trading by insiders. It treated such problems in Section 16 of the Act as separate and distinct from its treatment in Sections 9 and 10 of the Act of manipulative practices such as pooling arrangements, wash sales and matched orders. See Senate Reports Nos. 792 and 1455 (73d Cong., 2d Session, 1934).

The matter of trading on the basis of inside information was dealt with in Section 16 by providing for recovery of profits in the case of short-term trading and by reporting requirements in the case of long-term investment. The reasons for that treatment are stated in *Blau* v. *Max Factor & Co.*, 342 F. 2d 304 (9th Cir.), *cert. denied,* 382 U. S. 892 (1965), where the Court said (at 308):

> "The reasons which led Congress to declare insider profits on stock transactions forfeit only when purchase and sale occurred within less than six months, though not spelled out in the legislative materials, are nonetheless clear. Improper use of inside information by corporate insiders is most likely to occur in short-term, in-and-out trading. The temptation to trade upon inside information is enhanced when the period for which capital must be committed is short. And ordinarily the useful life of 'confidential' inside information is brief. The evidence upon which Congress acted indicated that the abuse occurred almost entirely in short-swing transactions. Moreover, few if any reasons could be advanced for encouraging such trading by insiders. On the other hand, in long-term investment the risk

> of abuse of inside information was relatively slight, and the affirmative value of long term personal financial commitments by insiders to the prosperity of the companies which they controlled was obviously great. Thus, by basing forfeiture of profits upon the length of the insider's investment commitment, Congress sought to minimize misuse of confidential information, without unduly discouraging bona fide long-term investment."

Petitioner does not contend that Section 16 preempts the field and that an insider's purchases, if fraudulent, would not violate Section 10(b) and Rule 10b-5. However, the fact that an insider's purchases, in the absence of fraud, were specifically regulated by Section 16 makes clear that Congress did not intend Section 10(b) to prohibit purchases on the basis of inside information unless those purchases also involved the separate and additional ingredients of fraud or deceit.

The restrictions on insider purchases superimposed on Rule 10b-5 by the Court below and applied retroactively to Coates may be proper subjects for legislation or the exercise of the Commission's rule-making powers, both of which operate prospectively. However, the question posed herein is not whether such restrictions may be proper or desirable but whether the challenged conduct comes within the existing Rule 10b-5 proscription against fraud and deceit.

> **(b) A director is not under a duty to disclose information which has already been announced by the corporation. In the absence of such a duty mere non-disclosure cannot constitute fraud or deceit.**

The charge against Coates is based upon the Commission's contention, accepted by the Court below, that under

Section 10(b) and Rule 10b-5 insiders may not purchase their corporation's securities without disclosing inside information to the seller and in the absence of disclosure the insider must abstain from buying. However, the only duty of disclosure created by Rule 10b-5 is contained in subdivision 2, which has no applicability to the charge against Coates. The other subdivisions of Rule 10b-5, *i.e.*, subdivisions (1) and (3), merely create a statutory liability for "fraud or deceit" and while one of the elements of fraud or deceit may be predicated upon the breach of a duty to disclose, such duty is not created by Rule 10b-5. Therefore, the question whether or not such duty exists depends on independent principles of law. In the context of a claim of fraud, mere nondisclosure is without legal significance unless the circumstances are such as to create a duty to disclose, so that nondisclosure is equivalent to misrepresentation.

The court below based its conclusion that subdivisions (1) and (3) should be read as if they create a duty of disclosure on what it termed (a) traditional fiduciary concepts and (b) the "special facts" doctrine enunciated by this Court in *Strong* v. *Repide,* 213 U. S. 419 (1909). However, it is settled law that no fiduciary duty is imposed upon officers and directors of a corporation which precludes them, merely because of their knowledge of inside information, from buying or selling the stock of their corporation. *Strong* v. *Repide, supra*; Securities Exchange Act of 1934, § 16 (15 U. S. C. § 78p); *SEC* v. *Chenery Corp.,* 318 U. S. 80, 88 (1943). Although courts have held that an insider has a duty to disclose if "special facts" exist, Coates' acts did not involve any of the facts and relationships which conceivably could be held to create a duty to disclose.* The

*As in *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U S. 180 (1963), where a registered investment adviser communicated only partial information to his clients to induce them to buy so that he could secretly sell after the price had advanced; or *Speed* v. *Trans-*

Court below apparently believed that the materiality of the information could itself be regarded as a "special fact" giving rise to a duty to disclose. But materiality is an independent element of fraud and this Court's opinion in *Strong* v. *Repide*, *supra*, makes clear that something more than the materiality of the information is required to constitute the special facts creating such duty.

In the absence of special facts, a corporate director is not under any duty to make disclosure of his knowledge of corporate affairs. It approaches absurdity to say that a seller of stock having routinely placed his order to sell on a securities exchange, without inquiry as to the expected Texas Gulf announcement, was entitled to expect that if any of his stock happened to be matched with a buy order of an insider, the buyer would communicate with him to disclose any material facts known to him.

Even if one were to assume, for purposes of argument, that a director possessed of inside information must disclose it prior to purchasing shares in the company, any such duty would cease when the company itself makes the disclosure. As of the moment that information is publicly announced it is "no longer available only for a corporate purpose" and is no longer inside. The information may, of course, be acted upon immediately by members of the public without any requirement that they make any disclosures to the persons with whom they are dealing. The corporate director has no less freedom of action.

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america Corp., 99 F. Supp. 808 (D. Del. 1951), modified on other grounds 235 F. 2d 369 (3d Cir. 1956), where a corporation, by withholding inventory data from financial statements, induced minority stockholders to sell their stock; or *Cochran* v. *Channing Corp.*, 211 F. Supp. 239 (S. D. N. Y. 1962), where a majority shareholder operated a scheme for depressing the market price of stock and buying out the minority.

Coates did not place his order and his transactions did not take place until after the corporation's public release at the news conference. Coates had no duty to make any disclosures in addition to those already made by Texas Gulf and he had no duty to wait for some undefined additional period of time before placing his order.

It may or may not be desirable to adopt a rule prescribing a waiting period for insiders in connection with the announcement of significant corporate news. But this is not a rule-making proceeding. In so far as Coates is concerned, the question is whether the fact that he purchased stock immediately after the public announcement "operated as a fraud or deceit." The news conference was attended by representatives of major brokerage firms who were free to and did make use of information presented at the meeting without any waiting period (R. 2385-90, 2424-26, 2432-34). Indeed, as noted by the Commission (Commission's Brief as Appellant in the Court of Appeals, p. 71), even a reporter could have called his stock broker before he called his office.

The contention that Coates had a duty to wait for a period of time following the public announcement has nothing to do with fraud or deceit but it is an unwarranted attempt to expand upon the inhibitions placed on insider trading by Section 16(b) of the Act. An analogous attempt (supported by the Commission as amicus) to expand the application of Section 16(b) was rejected by this Court in *Blau* v. *Lehman,* 368 U. S. 403 (1962).

The announcement by Texas Gulf at its news conference at 10 a. m. on April 16, 1964, was the culmination of a series of steps serving to inform stockholders and the public of the Timmins discovery. Accordingly, even if a corporate director had a duty to disclose inside information, the information ceased to be inside and any such duty terminated when the Timmins discovery was announced at the news conference.

II

A DIRECTOR'S PURCHASE OF STOCK ON INFORMATION WHICH HE BELIEVES TO BE AVAILABLE TO THE PUBLIC DOES NOT CONSTITUTE FRAUD OR DECEIT UNDER SECTION 10(b) OR RULE 10b-5.

We recognize, of course, that not every claim of fraud requires proof of all the elements of fraud required to establish a claim for damages. In no case or proceeding, however, prior to this one, has a defendant been held to have violated subdivisions (1) or (3) of Rule 10b-5, or any comparable provision, in the absence of proof of knowledge of falsity or deception. Thus, even if Section 10(b) and Rule 10b-5 are held to preclude insider trading on the basis of material inside information a corporate director cannot be held to have engaged in fraud and deceit in violation of that rule unless he knew that the information was still "inside" information.

The necessity of proving knowledge was specifically noted by the Court below in its statement that it is the essence of Rule 10b-5 that a director may not take advantage of information " 'intended to be available only for a corporate purpose' . . . *'knowing* it is unavailable to' . . . the investing public." (App. A, 3606. emphasis added) Nevertheless, in determining whether petitioner's good faith belief that the news was disseminated is a defense to a charge of fraud, the Court quite inconsistently held that it is not and that a director's honest error constitutes fraud. That holding appears to be based on an incorrect reading of this Court's opinion in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180 (1963). In that action this court held that in a proceeding under the Investment Advisers Act against a person subject to the supervision of the Commission, fraud could be established without proof of either "intent to injure" or "actual injury to the client". It did

not hold that negligence may be equated with fraud and expressly found the element of scienter to be present:

> "It is clear that respondents' failure to disclose the practice here in issue was purposeful, and that they intended that action be taken in reliance on the claimed disinterestedness of the service and its exclusive concern for the clients' interests." (375 U. S. at 192 fn. 39)

When Coates telephoned his broker after the April 16 news conference, he believed that Texas Gulf's Timmins discovery was no longer inside information. The record establishes that Coates' belief was a proper and reasonable one:

1. The public had been alerted on April 12, following widespread publication of rumors about a fantastic Texas Gulf discovery,* that a significant statement concerning the Timmins project would shortly be forthcoming (R. 1132-37, 1149-51, 1224-27, 2874-75).

2. At the Board meeting on April 16, Coates was informed (although erroneously) that the Ontario Minister of Mines had announced the discovery the night before and he assumed that it had been transmitted to New York brokerage houses through their wire connections with Canadian brokers (R. 171-72).**

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*The *New York Herald Tribune* front page article on April 11 referred to "the biggest ore strike since gold was discovered more than 60 years ago in Canada. . . ." (L-CX B)

**The Court of Appeals found that the announcement made by the Ontario Minister of Mines was not the equivalent of the announcement made by Texas Gulf in New York on April 16 (App. A, 3622). But the differences between the text of the New York press release (R. 58; Px. 19) and the announcement made by the Ontario Minister of Mines (R. 1023; Px. 74) are irrelevant to the question whether Coates' belief was reasonable. President Stephens did not read the text of the Minister's statement to the Board and did not give the Board members any indication that the Minister's announcement, which Stephens believed had been made the night before, differed in any material respect from the one to be made by Texas Gulf after the Board meeting (R. 1203-11).

3. The news conference that followed the Board meeting was attended by more than 22 representatives of the press, wire services and brokerage houses, including representatives of Dow Jones and of the brokerage firms of Merrill Lynch, Pierce, Fenner & Smith and Francis I. du Pont & Co. (R. 1266-69).

4. It was entirely reasonable for Coates to believe that news of the Timmins ore strike would be on the broad tape within minutes after the reporters left the press conference to make telephone calls. The entire conference lasted 10 to 15 minutes (R. 92, 151). Bishop, a staff reporter for Dow Jones, left the press conference shortly after it started and immediately telephoned the story to Dow Jones (R. 151-52, 165, 205, 2451-53). Coates assumed from his prior experience that the report would be on the broad tape in a matter of minutes (R. 166-68, 170). Bishop testified that if Dow Jones had followed its normal procedure, the news would have appeared on the broad tape within 2 to 3 minutes after he dictated it (R. 2454). Significantly, the first sentence of the Dow Jones transmission contained the full disclosure, *i.e.*, "Texas Gulf Sulphur Co. said its ore discovery in Ontario is—a major discovery of zinc copper and silver—" (R. 58; Px. 20, pp. 16-18).

The Court of Appeals' conclusion that Coates was negligent in believing that the news had appeared on the broad tape by 10:20 a.m. was based on its finding—a finding not made by the trial court—that the news could not have appeared until 2 minutes later, *i.e.*, 10:22. However, that finding reflects a misunderstanding of Bishop's testimony.*

*The Court of Appeals assumed that transmission on the broad tape begins only after the full story is dictated. However, Bishop

The record demonstrates that had Dow Jones followed its normal practice, the announcement of Texas Gulf's Timmins discovery would have been on the broad tape no later than 10:13 to 10:18, thereby confirming the reasonableness of Coates' belief that the news had already appeared on the broad tape when he telephoned his broker shortly before 10:20 a.m. His purchase, therefore, cannot on any theory constitute fraud or deceit under Section 10(b) or Rule 10b-5.

III

IF RULE 10b-5 IS NOW CONSTRUED TO MAKE UNLAWFUL A DIRECTOR'S PURCHASE OF STOCK ON INFORMATION WHICH HAS BEEN PUBLICLY ANNOUNCED AT A NEWS CONFERENCE THE RULE AS SO CONSTRUED IS INVALID UNDER THE FIFTH AMENDMENT FOR FAILURE TO PROVIDE AN ASCERTAINABLE STANDARD OF CONDUCT.

It is a fundamental constitutional requirement that administrative rules and regulations imposing civil or criminal** liability provide an ascertainable standard of conduct so that those subject to the law will know what it is they are prohibited from doing. *A. B. Small Co.* v. *American Sugar Refining Co.*, 267 U. S. 233 (1925); *Kraus & Bros., Inc.* v. *United States*, 327 U. S. 614 (1946); *Boyce Motor Lines, Inc.* v. *United States*, 342 U. S. 337 (1952); *Keyi-*

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testified that a story is dictated in segments or "takes" and that transmission begins immediately after the first take. Bishop testified that his telephone conversation with his office lasted 10 minutes and that the 10 minutes consisted of a "first take", "a wait" and a "second take". He stated that news normally appears on the broad tape within 2 to 3 minutes after the first take is dictated (R. 2453-54).

**While criminal penalties are not invoked in this case, violation of Rule 10b-5 is nevertheless punishable by fine and imprisonment. Section 32(a), 15 U. S. C. § 78 ff(a).

shian v. *Board of Regents,* 385 U. S. 589 (1967); *Boutilier* v. *Immigration and Naturalization Service,* 387 U. S. 118 (1967); *Matter of Ruffalo,* 390 U. S. 544 (1968).

As this Court stated in *Kraus & Bros., Inc.* v. *United States, supra*:

> ". . . The dividing line between unlawful evasion and lawful action cannot be left to conjecture. The elements of evasive conduct should be so clearly expressed by the Administrator that the ordinary person can know in advance how to avoid an unlawful course of action." (327 U. S. at 621-22)

The Court below construed antifraud Rule 10b-5 to apply to conduct untainted by fraud and to prohibit stock purchases by a director even after corporate information had been publicly announced. The standard of conduct which the Court below has thus read into Rule 10b-5 is not one which a reasonable man could divine from either Section 10(b) or Rule 10b-5 and the Court's retroactive application of that standard to Coates contravenes his basic constitutional rights.

Rule 10b-5 was adopted in 1942, its language having been taken substantially unchanged from Section 17 of the Securities Act of 1933. It was not until 1961 that the Commission first suggested that such language might be applied to buying or selling on the market on the basis of undisclosed inside information, in the absence of any misleading statement or conduct. *Matter of Cady, Roberts & Co.,* 40 S. E. C. 907. In that case, on a stipulated settlement, a partner of a brokerage firm was held by the SEC to have violated Rule 10b-5 by trading on the basis of information about a dividend reduction given to him by a director of the company prior to its public release. In that case,

the means selected for public release was not a news conference but, instead, communications to the New York Stock Exchange and Dow Jones. Both messages were inadvertently delayed in delivery. The announcement appeared on the Dow Jones broad tape three minutes after it was received (40 S. E. C. at 909) but, in the meantime, the transactions there in question had taken place. The SEC made no charge against the director, stating merely that he "probably assumed, without thinking about it, that the dividend action was already a matter of public information. . . ." (40 S. E. C. at 917)

By its decision in *Cady, Roberts,* the Commission disclosed for the first time its view that Rule 10b-5 could be construed to prohibit insider transactions without disclosure of inside information but it did not anywhere suggest that anything more was required that a public release of the information. On the contrary, the Commission stated:

> ". . . all the registered broker-dealer need do is to keep out of the market until the established procedures for public release of the information are carried out. . . ." (40 S. E. C. at 915)

In 1965, in its original complaint in this case, the Commission expanded its 1961 interpretation to require not only the carrying out of the procedure established for public release of information—here the news conference—but also the subsequent report of the announcement on the Dow Jones broad tape. It accordingly sought to impose liability on Coates for transactions that took place between the two events but did not then assert any claim against defendant Lamont for transactions after the report was carried on the broad tape.

In April 1966, just prior to the commencement of the trial of this case, the Commission further expanded its

interpretation of the Rule to include (by amendment to the complaint) a claim against Lamont for purchases in the afternoon on April 16, 1964, well after the appearance of the announcement on the Dow Jones tape (R. 4785).

In December, 1966, in its brief as Appellant in the Court of Appeals the Commission suggested still a different interpretation of the Rule, stating that insiders should not trade until the news appears "in the morning newspapers" and that a considerably longer time may be required to provide stockholders with some opportunity to evaluate the news and "consult with their advisers." (pp. 74, 75).

No Commission rules or regulations even purport to govern by express terms the purchase of stock after corporate announcements, and the Commission has conceded that there is "no court decision specifically involving the question when information has been sufficiently disseminated so that insiders may trade . . . ." (Commission's Brief as Appellant in Court of Appeals, p. 75). The only conceivable guidance Coates could have had was the Commission's decision in *Cady, Roberts,* which stated that an insider must "keep out of the market until the established procedures for *public release* of the information are *carried out* . . ." [emphasis supplied], which is what Coates did, being "too old to get into trouble with the SEC" (R. 162).

The confusion engendered by the Commission's varying interpretations of the Rule is compounded by its refusal, even up to the present, to define the standard of conduct which it claims already exists in Rule 10b-5. In attempting to justify this refusal the Commission has conceded the absence of an ascertainable standard. Thus, the Commission attempts to justify its refusal on the grounds that: (1) it is "a nearly impossible task to formulate a rigid set of rules that would apply in all situations of this sort" (R. 2830); (2) "a standard is difficult to formulate" (R.

2838); (3) "standards that Congress and the Commission set must necessarily be stated in somewhat general terms, as they have been stated in Rule 10b-5" (R. 2848) and (4) "specific rules . . . would be undesirable" (Commission's Brief as Appellant in the Court of Appeals, p. 76).

If the Court of Appeals is capable of articulating a minimum *post hoc* standard* then the Commission should be capable of drafting, and required to promulgate a standard, prior to bringing an action for violation of the Rule. Even the Court of Appeals called upon the Commission, in its expertise, to exercise its rule-making power to "provide some predictability of certainty for the business community." (App. A, 3618 fn. 18)

Yet, the Commission has used the litigation that it instituted as a justification for its failure to promulgate guidelines.** Manuel F. Cohen, Chairman of the Commission, is reported to have asserted to the Investment Bankers Association of America on December 5, 1968, that "the Commission does plan to issue some guidelines . . ." but they haven't been issued yet "because it would be unseemly while various legal cases are still in the courts." *Wall Street Journal* Dec. 6, 1968, p. 15.

If the Commission itself, after more than 30 years experience with the Rule, has so much difficulty in deciding what construction to place upon it, it cannot reasonably be said that the Rule provides an ascertainable standard of conduct so that "the ordinary person can know in advance how to avoid an unlawful course of action".

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*"[A]t the minimum, Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow-Jones broad tape . . . ." (App. A, 3618-19)

**The decision of the Court of Appeals frees the Commission from the necessity of promulgating regulations in advance and allows the Commission to assert a new "construction" of an existing regulation to be applied retroactively.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

January 3, 1969

Respectfully submitted

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 296—September Term, 1966.

(Argued March 20, 1967
Submitted to the *in banc* Court May 2, 1968
Decided August 13, 1968.)

Docket No. 30882

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

—v.—

TEXAS GULF SULPHUR Co., a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, WALTER HOLYK, KENNETH H. DARKE, FRANCIS G. COATES, CLAUDE O. STEPHENS, JOHN A. MURRAY, EARL L. HUNTINGTON, and HAROLD B. KLINE,

Defendants-Appellees.

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

—v.—

DAVID M. CRAWFORD and RICHARD H. CLAYTON,

Defendants-Appellants.

Before:

LUMBARD, *Chief Judge*,

WATERMAN, MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS, ANDERSON and FEINBERG, *Circuit Judges*.

In the United States District Court for the Southern District of New York the Securities and Exchange Commission commenced its action pursuant to 15 U. S. C. §§78u, 78aa, against Texas Gulf Sulphur Company and thirteen individuals alleging violations by the fourteen defendants of the provisions of Section 10b of the Securities Exchange Act of 1934, 15 U. S. C. §78j(b), and its Rule 10b-5 (17 C. F. R. 240.10b-5) promulgated pursuant to the authority granted to it in Section 10b.

The court below, Bonsal, *J.*, found that two of the individual defendants, Clayton and Crawford, had violated Section 10b and Rule 10b-5, but otherwise the Commission's complaint was ordered dismissed, 258 F. Supp. 262 (1966).

Appeals were taken by the Commission and by Clayton and Crawford. Eleven of the thirteen original individual defendants, and the corporation, are parties in the proceedings before us.

The appeals were argued before a division of the court consisting of Judges Waterman, Moore, and Hays. When the opinions prepared by them were distributed to the other judges of the court it was ordered on May 2, 1968 that the case should, without further argument, be considered *in banc* upon the record and briefs the parties had filed and upon the opinions that had been prepared and distributed by the panel judges. After *in banc* consideration the opinions appearing hereafter were prepared. The results reached in Judge Waterman's opinion for the court are

concurred in unanimously as to appellee Coates, and appellants Clayton and Crawford; as to the remaining contested issues that opinion represents results concurred in either generally or in separate statements by a majority of the judges.

The dispositions below as to appellants Clayton and Crawford are affirmed. As to one of the appellees, Murray, the disposition below is affirmed. As to the remaining individual appellees and the corporation, the order dismissing the complaint is reversed and the cause remanded for further proceedings below consistent with the opinion of the court.

PHILIP A. LOOMIS, JR., Gen. Counsel; DAVID FERBER, Solicitor; ROGER S. FOSTER, Spec. Counsel, Ofc. of Policy Research, SEC; FRANK E. KENNAMER, JR., Asst. Gen. Counsel; DONALD M. FEUERSTEIN, Atty., SEC, *for Securities and Exchange Commission.*

ORISON S. MARDEN, White & Case, WILLIAM D. CONWELL, EDWARD C. SCHMULTS, P. R. KONRAD KNAKE, THOMAS McGANNEY, PETER G. EIKENBERRY, New York City, *for Texas Gulf Sulphur, Fogarty, Mollison, Holyk, Darke, Stephens, Murray, Huntington and Kline, Crawford and Clayton.*

ALBERT R. CONNELLY, DONALD I. STRAUBER, Cravath, Swaine & Moore, New York City, *for Coates.*

WATERMAN, *Circuit Judge*:

This action was commenced in the United States District Court for the Southern District of New York by the

Securities and Exchange Commission (the SEC) pursuant to Sec. 21(e) of the Securities Exchange Act of 1934 (the Act), 15 U. S. C. §78u(e), against Texas Gulf Sulphur Company (TGS) and several of its officers, directors and employees, to enjoin certain conduct by TGS and the individual defendants said to violate Section 10(b) of the Act, 15 U. S. C. Section 78j(b), and Rule 10b-5 (17 CFR 240.10b-5) (the Rule), promulgated thereunder, and to compel the rescission by the individual defendants of securities transactions assertedly conducted contrary to law.[1] The complaint alleged (1) that defendants Fogarty, Mollison, Darke, Murray, Huntington, O'Neill, Clayton, Crawford, and Coates had either personally or through agents purchased TGS stock or calls thereon from November 12, 1963 through April 16, 1964 on the basis of material inside information concerning the results of TGS drilling in Timmins, Ontario, while such information remained undisclosed to the investing public generally or to the particular sellers[2]; (2) that defendants Darke and Coates had di-

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1 Pursuant to a stipulation by all parties, the question of the appropriate remedies to be applied was deferred pending a final determination whether the defendants or any of them had violated Section 10(b) and Rule 10b-5 and therefore that question is not now before us.

2 The purchases by the parties during this period were:

Purchase		*Shares*		*Calls*	
Date	*Purchaser*	*Number*	*Price*	*Number*	*Price*
Hole K-55-1 Completed November 12, 1963					
1963					
Nov. 12	Fogarty	300	17¾-18		
15	Clayton	200	17¾		
15	Fogarty	700	17⅝-17⅞		
15	Mollison	100	17⅞		
19	Fogarty	500	18⅛		
26	Fogarty	200	17¾		
29	Holyk (Mrs.)	50	18		
Chemical Assays of Drill Core of K-55-1 Received December 9-13, 1963					

(*footnote continued on next page*)

vulged such information to others for use in purchasing TGS stock or calls[3] or recommended its purchase while the

Purchase Date	*Purchaser*	*Shares Number*	*Shares Price*	*Calls Number*	*Calls Price*
1963					
Dec. 10	Holyk (Mrs.)	100	20⅜		
12	Holyk (or wife)			200	21
13	Mollison	100	21⅛		
30	Fogarty	200	22		
31	Fogarty	100	23¼		
1964					
Jan. 6	Holyk (or wife)			100	23⅝
8	Murray			400	23¼
24	Holyk (or wife)			200	22¼-22⅜
Feb. 10	Fogarty	300	22⅛-22¼		
20	Darke	300	24⅛		
24	Clayton	400	23⅞		
24	Holyk (or wife)			200	24⅛
26	Holyk (or wife)			200	23⅜
26	Huntington	50	23¼		
27	Darke (Moran as nominee)			1000	22⅝-22¾
Mar. 2	Holyk (Mrs.)	200	22⅜		
3	Clayton	100	22¼		
16	Huntington			100	22⅜
16	Holyk (or wife)			300	23¼
17	Holyk (Mrs.)	100	23⅞		
23	Darke			1000	24¾
26	Clayton	200	25		
Land Acquisition Completed March 27, 1964					
Mar. 30	Darke			1000	25½
30	Holyk (Mrs.)	100	25⅞		
Core Drilling of Kidd Segment Resumed March 31, 1964					
April 1	Clayton	60	26½		
1	Fogarty	400	26½		
2	Clayton	100	26⅞		
6	Fogarty	400	28⅛-28⅞		
8	Mollison (Mrs.)	100	28⅛		
First Press Release Issued April 12, 1964					
April 15	Clayton	200	29⅜		
16	Crawford (and wife)	600	30⅛-30¼		
Second Press Release Issued 10:00-10:10 or 10:15 A.M., April 16, 1964					
April 16 (app. 10:20 A.M.)	Coates (for family trusts)	2000	31 -31⅝		

3 A "call" is a negotiable option contract by which the bearer has the right to buy from the writer of the contract a certain number of shares of a particular stock at a fixed price on or before a certain agreed-upon date.

information was undisclosed to the public or to the sellers;[4] that defendants Stephens, Fogarty, Mollison, Holyk, and

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4 The purchases made by "tippees" during this period were:

Purchase Date	*Purchaser*	*Shares Number*	*Shares Price*	*Calls Number*	*Calls Price*
Chemicals Assays of K-55-1 Received Dec. 9-13, 1963					
1963					
Dec. 30	Caskey (Darke)			300	22¼
1964					
Jan. 16	Westreich (Darke)	2000	21¼-21¾		
Feb. 17	Atkinson (Darke)	50	23¼	200	23⅛
17	Westreich (Darke)	50	23¼	1000	23¼-23⅜
24	Miller (Darke)			200	23¾
25	Miller (Darke)			300	23⅜-23½
Mar. 3	E. W. Darke (Darke)			500	22½-22⅝
17	E. W. Darke (Darke)			200	23⅜
Land Acquisition Completed Mar. 27, 1964					
1964					
Mar. 30	Atkinson (Darke)			400	25¾-25⅞
	Caskey (Darke)	100	25⅞		
	E. W. Darke (Darke)			1000	25¾-25⅞
	Miller (Darke)			200	25½
	Westreich (Darke)	500	25¾		
30-31	Klotz (Darke)			2000	25½-26⅛
Second Press Release Issued April 16, 1964 (Reported over Dow Jones tape at 10:54 A.M.)					
April 16 (from 10:31 A.M.)					
	Haemisegger (Coates)	1500	31¼-35		

In this connection, we point out that, though several of the Holyk purchases of shares and calls made between November 29, 1963 and March 30, 1964 were in the name of Mrs. Holyk or were in the names of both spouses, we have treated these purchases as if made in the name of defendant Holyk alone.

Defendant Mollison purchased 100 shares on November 15 in his name only and on April 8 100 shares were purchased in the name of Mrs. Mollison. We have made no distinction between those purchases.

Defendant Crawford ordered 300 shares about midnight on April 15 and 300 more shares the following morning, to be purchased for himself, and his wife, and these purchases are treated as having been made by the defendant Crawford.

In these particulars we have followed the lead of the court below. See the table at 258 F. Supp. 273-275 and the special references to the Holyk purchases at 273, and the Crawford purchases at 287. It would be unrealistic to include any of these purchases as having been made by other than the defendants, and unrealistic to include them as having been made by members of the general public receiving "tips" from insiders.

Kline had accepted options to purchase TGS stock on Feb. 20, 1964 without disclosing the material information as to the drilling progress to either the Stock Option Committee or the TGS Board of Directors; and (4) that TGS issued a deceptive press release on April 12, 1964. The case was tried at length before Judge Bonsal of the Southern District of New York, sitting without a jury. Judge Bonsal in a detailed opinion[5] decided, *inter alia*, that the insider activity prior to April 9, 1964 was not illegal because the drilling results were not "material" until then; that Clayton and Crawford had traded in violation of law because they traded after that date; that Coates had committed no violation as he did not trade before disclosure was made; and that the issuance of the press release was not unlawful because it was not issued for the purpose of benefiting the corporation, there was no evidence that any insider used the release to his personal advantage and it was not "misleading, or deceptive on the basis of the facts then known," 258 F. Supp. 262, at 292-296 (SDNY 1966). Defendants Clayton and Crawford appeal from that part of the decision below which held that they had violated Sec. 10(b) and Rule 10b-5 and the SEC appeals from the remainder of the decision which dismissed the complaint against defendants TGS, Fogarty, Mollison, Holyk, Darke, Stephens, Kline, Murray, and Coates.[6]

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5 258 F. Supp. 262 (SDNY 1966).

6 Defendant O'Neill did not appear to answer the charge against him; the SEC motion to enter a default judgment against him was denied without prejudice to its renewal upon completion of this appeal.

Shortly after the appeal was argued defendant Lamont passed away, and by agreement of the parties an order was entered discontinuing his appeal and directing that the judgment below dismissing the action against him be severed from the judgment as to the other defendants.

The SEC does not contest the alternative holding below that Holyk and Mollison, not being members of TGS's top management, had no duty of disclosure prior to acceptance of stock options.

For reasons which appear below, we decide the various issues presented as follows:

(1) As to Clayton and Crawford, as purchasers of stock on April 15 and 16, 1964, we affirm the finding that they violated 15 U. S. C. §78j(b) and Rule 10b-5 and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(2) As to Murray, we affirm the dismissal of the complaint.

(3) As to Mollison and Holyk, as recipients of certain stock options, we affirm the dismissal of the complaint.

(4) As to Stephens and Fogarty, as recipients of stock options, we reverse the dismissal of the complaint and remand for a further determination as to whether an injunction, in the exercise of the trial court's discretion, should issue.

(5) As to Kline, as a recipient of a stock option, we reverse the dismissal of the complaint and remand with directions to issue an order rescinding the option and for a determination of any other appropriate remedy in connection therewith.

(6) As to Fogarty, Mollison, Holyk, Darke, and Huntington, as purchasers of stock or calls thereon between November 12, 1963, and April 9, 1964, we reverse the dismissal of the complaint and find that they violated 15 U. S. C. §78j(b) and Rule 10b-5, and remand, pursuant to the agreement of all the parties, for a determination of the appropriate remedy.

(7) As to Clayton, although the district judge did not specify that the complaint be dismissed with respect to

his purchases of TGS stock before April 9, 1964, such a dismissal is implicit in his treatment of the individual appellees who acted similarly. Consequently, although Clayton is named only as an appellant our decision with respect to the materiality of K-55-1 renders it necessary to treat him also as an appellee. Thus, as to him, as one who purchased stock between November 12, 1963 and April 9, 1964, we reverse the implicit dismissal of the complaint, find that he violated §78j(b) and Rule 10b-5, and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(8) As to Drake, as one who passed on information to tippees, we reverse the dismissal of the complaint and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(9) As to Coates, as one who on April 16th purchased stock and gave information on which his son-in-law broker and the broker's customers purchased shares, we reverse the dismissal of the complaint, find that he violated 15 U. S. C. §78j(b) and Rule 10b-5, and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(10) As to Texas Gulf Sulphur, we reverse the dismissal of the complaint and remand for a further determination by the district judge in the light of the approach taken in this opinion.

The occurrences out of which this litigation arose are not set forth hereafter in as detailed a manner as they are set out in the published opinion of the court below, but are stated sufficiently, we believe, for the exposition of the issues raised by the several appeals to us.

The Factual Setting

This action derives from the exploratory activities of TGS begun in 1957 on the Canadian Shield in eastern Canada. In March of 1959, aerial geophysical surveys were conducted over more than 15,000 square miles of this area by a group led by defendant Mollison, a mining engineer and a Vice President of TGS. The group included defendant Holyk, TGS's chief geologist, defendant Clayton, an electrical engineer and geophysicist, and defendant Darke, a geologist. These operations resulted in the detection of numerous anomalies, i.e., extraordinary variations in the conductivity of rocks, one of which was on the Kidd 55 segment of land located near Timmins, Ontario.

On October 29 and 30, 1963, Clayton conducted a ground geophysical survey on the northeast portion of the Kidd 55 segment which confirmed the presence of an anomaly and indicated the necessity of diamond core drilling for further evaluation. Drilling of the initial hole, K-55-1, at the strongest part of the anomaly was commenced on November 8 and terminated on November 12 at a depth of 655 feet. Visual estimates by Holyk of the core of K-55-1 indicated an average copper content of 1.15% and an average zinc content of 8.64% over a length of 599 feet. This visual estimate convinced TGS that it was desirable to acquire the remainder of the Kidd 55 segment, and in order to facilitate this acquisition TGS President Stephens instructed the exploration group to keep the results of K-55-1 confidential and undisclosed even as to other officers, directors, and employees of TGS. The hole was concealed and a barren core was intentionally drilled off the anomaly. Meanwhile, the core of K-55-1 had been shipped to U h for chemical assay which, when received in early December, revealed an average mineral content of 1.18% copper, 8.26%

zinc, and 3.94% ounces of silver per ton over a length of 602 feet. These results were so remarkable that neither Clayton, an experienced geophysicist, nor four other TGS expert witnesses, had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit. So, the trial court concluded, "There is no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it." *Id.* at 282. By March 27, 1964, TGS decided that the land acquisition program had advanced to such a point that the company might well resume drilling, and drilling was resumed on March 31.

During this period, from November 12, 1963 when K-55-1 was completed, to March 31, 1964 when drilling was resumed, certain of the individual defendants listed in fn. 2, *supra,* and persons listed in fn. 4, *supra,* said to have received "tips" from them, purchased TGS stock or calls thereon. Prior to these transactions these persons had owned 1135 shares of TGS stock and possessed no calls; thereafter they owned a total of 8235 shares and possessed 12,300 calls.

On February 20, 1964, also during this period, TGS issued stock options to 26 of its officers and employees whose salaries exceeded a specified amount, five of whom were the individual defendants Stephens, Fogarty, Mollison, Holyk, and Kline. Of these, only Kline was unaware of the detailed results of K-55-1, but he, too, knew that a hole containing favorable bodies of copper and zinc ore had been drilled in Timmins. At this time, neither the TGS Stock Option Committee nor its Board of Directors had been informed of the results of K-55-1, presumably because of the pending land acquisition program which required confidentiality. All of the foregoing defendants accepted the options granted them.

When drilling was resumed on March 31, hole K-55-3 was commenced 510 feet west of K-55-1 and was drilled easterly at a 45° angle so as to cross K-55-1 in a vertical plane. Daily progress reports of the drilling of this hole K-55-3 and of all subsequently drilled holes were sent to defendants Stephens and Fogarty (President and Executive Vice President of TGS) by Holyk and Mollison. Visual estimates of K-55-3 revealed an average mineral content of 1.12% copper and 7.93% zinc over 641 of the hole's 876-foot length. On April 7, drilling of a third hole, K-55-4, 200 feet south of and parallel to K-55-1 and westerly at a 45° angle, was commenced and mineralization was encountered over 366 of its 579-foot length. Visual estimates indicated an average content of 1.14% copper and 8.24% zinc. Like K-55-1, both K-55-3 and K-55-4 established substantial copper mineralization on the eastern edge of the anomaly. On the basis of these findings relative to the foregoing drilling results, the trial court concluded that the vertical plane created by the intersection of K-55-1 and K-55-3, which measured at least 350 feet wide by 500 feet deep extended southward 200 feet to its intersection with K-55-4, and that "There was real evidence that a body of commercially mineable ore might exist." *Id.* at 281-82.

On April 8 TGS began with a second drill rig to drill another hole, K-55-6, 300 feet easterly of K-55-1. This hole was drilled westerly at an angle of 60° and was intended to explore mineralization beneath K-55-1. While no visual estimates of its core were immediately available, it was readily apparent by the evening of April 10 that substantial copper mineralization had been encountered over the last 127 feet of the hole's 569-foot length. On April 10, a third drill rig commenced drilling yet another hole, K-55-5, 200 feet north of K-55-1, parallel to the prior

holes, and slanted westerly at a 45° angle. By the evening of April 10 in this hole, too, substantial copper mineralization had been encountered over the last 42 feet of its 97-foot length.

Meanwhile, rumors that a major ore strike was in the making had been circulating throughout Canada. On the morning of Saturday, April 11, Stephens at his home in Greenwich, Conn. read in the New York Herald Tribune and in the New York Times unauthorized reports of the TGS drilling which seemed to infer a rich strike from the fact that the drill cores had been flown to the United States for chemical assay. Stephens immediately contacted Fogarty at his home in Rye, N. Y., who in turn telephoned and later that day visited Mollison at Mollison's home in Greenwich to obtain a current report and evaluation of the drilling progress.[7] The following morning, Sunday, Fogarty again telephoned Mollison, inquiring whether Mollison had any further information and told him to return to Timmins with Holyk, the TGS Chief Geologist, as soon as possible "to move things along." With the aid of one Carroll, a public relations consultant, Fogarty drafted a press release designed to quell the rumors, which release, after having been channeled through Stephens and Huntington, a TGS attorney, was issued at 3:00 P.M. on Sunday, April 12, and which appeared in the morning newspapers of general circulation on Monday, April 13. It read in pertinent part as follows:

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7 Mollison had returned to the United States for the weekend. Friday morning, April 10, he had been on the Kidd tract "and had been advised by defendant Holyk as to the drilling results to 7:00 p.m. on April 10. At that time drill holes K-55-1, K-55-3 and K-55-4 had been completed; drilling of K-55-5 had started on Section 2200 S and had been drilled to 97 feet, encountering mineralization on the last 42 feet; and drilling of K-55-6 had been started on Section 2400 S and had been drilled to 569 feet, encountering mineralization over the last 127 feet." *Id.* at 294.

NEW YORK, April 12—The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:

"During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.

"The facts are as follows. TGS has been exploring in the Timmins area for six years as part of its overall search in Canada and elsewhere for various minerals—lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.

"Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.

"Recent drilling on one property near Timmins has led to preliminary indications that more drilling would

be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

"The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

* * * * *

The release purported to give the Timmins drilling results as of the release date, April 12. From Mollison Fogarty had been told of the developments through 7:00 P.M. on April 10, and of the remarkable discoveries made up to that time, detailed *supra,* which discoveries, according to the calculations of the experts who testified for the SEC at the hearing, demonstrated that TGS had already discovered 6.2 to 8.3 million tons of proven ore having gross assay values from $26 to $29 per ton. TGS experts, on the other hand, denied at the hearing that proven or probable ore could have been calculated on April 11 or 12 because there was then no assurance of continuity in the mineralized zone.

The evidence as to the effect of this release on the investing public was equivocal and less than abundant. On April 13 the New York Herald Tribune in an article head-noted "Copper Rumor Deflated" quoted from the TGS release of April 12 and backtracked from its original April 11 report

of a major strike but nevertheless inferred from the TGS release that "recent mineral exploratory activity near Timmins, Ontario, has provided preliminary favorable results, sufficient at least to require a step-up in drilling operations." Some witnesses who testified at the hearing stated that they found the release encouraging. On the other hand, a Canadian mining security specialist, Roche, stated that "earlier in the week [before April 16] we had a Dow Jones saying that they [TGS] didn't have anything basically" and a TGS stock specialist for the Midwest Stock Exchange became concerned about his long position in the stock after reading the release. The trial court stated only that "While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known." *Id.* at 296.

Meanwhile, drilling operations continued. By the morning of April 13, in K-55-5, the fifth drill hole, substantial copper mineralization had been encountered to the 580 foot mark, and the hole was subsequently drilled to a length of 757 feet without further results. Visual estimates revealed an average content of 0.82% copper and 4.2% zinc over a 525-foot section. Also by 7:00 A.M. on April 13, K-55-6 had found mineralization to the 946-foot mark. On April 12 a fourth drill rig began to drill K-55-7, which was drilled westerly at a 45° angle, at the eastern edge of the anomaly. The next morning the 137 foot mark had been reached, fifty feet of which showed mineralization. By 7:00 P.M. on April 15, the hole had been completed to a length of 707 feet but had only encountered additional mineralization during a 26-foot length between the 425 and 451-foot marks. A mill test hole, K-55-8, had been drilled and was complete by the evening of April 13 but its mineralization had not been reported upon prior to April

16. K-55-10 was drilled westerly at a 45° angle commencing April 14 and had encountered mineralization over 231 of its 249-foot length by the evening of April 15. It, too, was drilled at the anomaly's eastern edge.

While drilling activity ensued to completion, TGS officials were taking steps toward ultimate disclosure of the discovery. On April 13, a previously-invited reporter for The Northern Miner, a Canadian mining industry journal, visited the drillsite, interviewed Mollison, Holyk and Darke, and prepared an article which confirmed a 10 million ton ore strike. This report, after having been submitted to Mollison and returned to the reporter unamended on April 15, was published in the April 16 issue. A statement relative to the extent of the discovery, in substantial part drafted by Mollison, was given to the Ontario Minister of Mines for release to the Canadian media. Mollison and Holyk expected it to be released over the airways at 11 P.M. on April 15th, but, for undisclosed reasons, it was not released until 9:40 A.M. on the 16th. An official detailed statement, announcing a strike of at least 25 million tons of ore, based on the drilling data set forth above, was read to representatives of American financial media from 10:00 A.M. to 10:10 or 10:15 A.M. on April 16, and appeared over Merrill Lynch's private wire at 10:29 A.M. and, somewhat later than expected, over the Dow Jones ticker tape at 10:54 A.M.

Between the time the first press release was issued on April 12 and the dissemination of the TGS official announcement on the morning of April 16, the only defendants before us on appeal who engaged in market activity were Clayton and Crawford and TGS director Coates. Clayton ordered 200 shares of TGS stock through his Canadian

broker on April 15 and the order was executed that day over the Midwest Stock Exchange. Crawford ordered 300 shares at midnight on the 15th and another 300 shares at 8:30 A.M. the next day, and these orders were executed over the Midwest Exchange in Chicago at its opening on April 16. Coates left the TGS press conference and called his broker son-in-law Haemisegger shortly before 10:20 A.M. on the 16th and ordered 2,000 shares of TGS for family trust accounts of which Coates was a trustee but not a beneficiary; Haemisegger executed this order over the New York and Midwest Exchanges, and he and his customers purchased 1500 additional shares.

During the period of drilling in Timmins, the market price of TGS stock fluctuated but steadily gained overall. On Friday, November 8, when the drilling began, the stock closed at 17⅜; on Friday, November 15, after K-55-1 had been completed, it closed at 18. After a slight decline to 16⅜ by Friday, November 22, the price rose to 20⅞ by December 13, when the chemical assay results of K-55-1 were received, and closed at a high of 24⅛ on February 21, the day after the stock options had been issued. It had reached a price of 26 by March 31, after the land acquisition program had been completed and drilling had been resumed, and continued to ascend to 30⅛ by the close of trading on April 10, at which time the drilling progress up to then was evaluated for the April 12th press release. On April 13, the day on which the April 12 release was disseminated, TGS opened at 30⅛, rose immediately to a high of 32 and gradually tapered off to close at 30⅞. It closed at 30¼ the next day, and at 29⅜ on April 15. On April 16, the day of the official announcement of the Timmins discovery, the price climbed to a high of 37 and closed at 36⅜. By May 15, TGS stock was selling at 58¼.

I. The Individual Defendants

A. *Introductory*

Rule 10b-5, 17 CFR 240.10b-5, on which this action is predicated, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934 (15 U. S. C. 78j(b).[8]

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8 15 U. S. C. §78j reads in pertinent part as follows:

§78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device

By that Act Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges, see 3 Loss, Securities Regulation 1455-56 (2d ed. 1961). The Act and the Rule apply to the transactions here, all of which were consummated on exchanges. See *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 461-62 (2 Cir.), *cert. denied*, 382 U. S. 811 (1965); *Cochran* v. *Channing Corp.*, 211 F. Supp. 239, 243 (SDNY 1962). Whether predicated on traditional fiduciary concepts, see, e.g., *Hotchkiss* v. *Fisher*, 16 P. 2d 531 (Kan. 1932), or on the "special facts" doctrine, see, e.g., *Strong* v. *Repide*, 213 U. S. 419 (1909), the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information, see Cary, Insider Trading in Stocks, 21 Bus. Law. 1009, 1010 (1966), Fleischer, Securities Trading and Corporation Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1278-80 (1965). The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. *Matter of Cady, Roberts & Co.*, 40 SEC 907, 912 (1961). Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one

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or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the Act. *Cady, Roberts, supra.* Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material,[9] its possessors should have kept out of the market until disclosure was accomplished. *Cady, Roberts, supra* at 911.

B. *Material Inside Information*

An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in "those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed." Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1289.

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9 Congress intended by the Exchange Act to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office. See Sections 2 and 16 of the Act; H. R. Rep. No. 1383, 73rd Cong., 2d Sess. 13 (1934); S. Rep. No. 792, 73rd Cong., 2d Sess. 9 (1934); S. E. C., Tenth Annual Report 50 (1944). See *Cady, Roberts, supra* at 912.

Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions. 3 Loss, *op. cit. supra* at 1463. The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

This is not to suggest, however, as did the trial court, that "the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight," 258 F. Supp. 262 at 280, in the sense that the materiality of facts is to be assessed solely by measuring the effect the knowledge of the facts would have upon prudent or conservative investors. As we stated in *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462, "The basic test of materiality . . . is whether a *reasonable* man would attach importance . . . in determining his choice of action in the transaction in question. Restatement, Torts §538(2)(a); accord Prosser, Torts 554-55; I Harper & James, Torts 565-66." (Emphasis supplied.) This, of course, encompasses any fact ". . . which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities. . . ." *List* v. *Fashion Park, Inc., supra* at 462, quoting from *Kohler* v. *Kohler Co.*, 319 F. 2d 634, 642 (7 Cir. 1963). (Emphasis supplied.) Such a fact is a material fact and must be effectively disclosed to the investing public prior to the commencement of insider trading in the corporation's securities. The speculators and chartists of Wall and Bay Streets are also "reasonable" investors entitled to the same

legal protection afforded conservative traders.[10] Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.

In each case, then, whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. Here, notwithstanding the trial court's conclusion that the results of the first drill core, K-55-1, were "too 'remote' . . . to have had any significant impact on the market, i.e., to be deemed material,"[11] 258 F. Supp. at 283, knowledge of the possibility, which surely was

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10 The House of Representatives committee that reported out the bill which eventually became the Act did so with the observation that "no investor, *no speculator*, can safely buy and sell securities upon exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." H. R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 11. (Emphasis supplied.)

Dr. Bellemore, the Texas Gulf defendants' expert witness, has written: "The intelligent speculator assumes that facts are available for a thorough analysis. The speculator then examines the facts to discover and evaluate the risks that are present. He then balances these risks against the apparent opportunities for capital gains and makes his decision accordingly. He is, to the best of his ability, taking calculated risks." Bellemore, Investments: Principles, Practices and Analysis 4 (2d ed. 1962).

11 We are not, of course, bound by the trial court's determination as to materiality unless we find it "clearly erroneous" for that standard of appellate review is applicable only to issues of basic fact and not to issues of ultimate fact. See *Baranow* v. *Gibraltar Factors Corp.*, 366 F. 2d 584, 587 (2 Cir. 1966); *Mamiye Bros.* v. *Barber S.S. Lines, Inc.*, 360 F. 2d 774, 776-78 (2 Cir.), cert. denied, 385 U. S. 835 (1966); see also *SEC* v. *R. A. Holman & Co.*, 366 F. 2d 456, 457-58 (2 Cir. 1966) (by implication).

more than marginal, of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface (suggesting mineability by the less expensive open-pit method) within the confines of a large anomaly (suggesting an extensive region of mineralization) might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold. After all, this first drill core was "unusually good and . . . excited the interest and speculation of those who knew about it." 258 F. Supp. at 282.

Our disagreement with the district judge on this issue does not, then, go to his findings of basic fact, as to which the "clearly erroneous" rule would apply, but to his understanding of the legal standard applicable to them. See *In re Hygrade Envelope Corp.*, 366 F. 2d 584, 587-89 (2 Cir. 1966), and cases cited in footnote 11 *supra*. Our survey of the facts found below conclusively establishes that knowledge of the results of the discovery hole, K-55-1, would have been important to a reasonable investor and might have affected the price of the stock.[12] On April 16, *The Northern Miner*, a trade publication in wide circulation among mining stock specialists, called K-55-1, the discovery hole, "one of the most impressive drill holes completed in

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12 We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC. Here, a valuable corporate purpose was served by delaying the publication of the K-55-1 discovery. We do intend to convey, however, that where a corporate purpose is thus served by withholding the news of a material fact, those persons who are thus quite properly true to their corporate trust must not during the period of non-disclosure deal personally in the corporation's securities or give to outsiders confidential information not generally available to all the corporations' stockholders and to the public at large.

modern times."[13] Roche, a Canadian broker whose firm specialized in mining securities, characterized the importance to investors of the results of K-55-1. He stated that the completion of "the first drill hole" with "a 600 foot drill core is very very significant . . . anything over 200 feet is considered very significant and 600 feet is just beyond your wildest imagination." He added, however, that it "is a natural thing to buy more stock once they give you the first drill hole." Additional testimony revealed that the prices of stocks of other companies, albeit less

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13 The April 16th article in The Northern Miner resulted from the reporter's April 13th visit to the drill site where he interviewed defendants Mollison, Holyk and Darke and looked at records of the drilling to that time. The text of the article was approved by Mollison in Timmins on April 15th. The first five paragraphs read as follows:

Should Make Substantial Open Pit Operation

TEXAS GULF SULPHUR COMES UP WITH A "MAJOR"

See Big Tonnages Of Base Metals, Plus Silver

Texas Gulf Sulphur has chalked up a brilliant exploration success in its field program north of the Porcupine area. Following a visit to the discovery property, The Northern Miner can say that a major new zinc-copper-silver mine is definitely in the making, one that has all the earmarks of shaping into a substantial open pit operation.

Only a relative handful of holes has been completed since the discovery hole but on the basis of seven tests either completed or drilling it can be stated that a strike length of 600 ft. minimum has been established, showing an ore width of roughly 300 ft. which has been traced so far to a maximum vertical depth of about 800 ft.

So recent has been the discovery, and so urgent the effort to accelerate the drill program (four machines have been moved in since the discovery hole was completed), that assays have been completed on only the discovery. But this must be recorded as one of the most impressive drill holes completed in modern times.

For a core length of a shade better than 600 ft., the hole averaged in excess of 1% copper, 8% zinc and nearly four ounces of silver.

And there are impressive, strong sections within this width which in themselves are quite spectacular. In the upper part of the hole, for example, a core length of 82 ft. ran 7.1% copper, 9.7% zinc and 2.4 ozs. silver. This was followed by continuous values of ore tenor—deeper down, a 100-ft. section runs 0.33% copper, 0.8% lead, 14.3% zinc and 4.2 ozs. silver. And still deeper, a strong zinc section of better than 100 ft. averaged out to in excess of seven ounces of silver in addition to ore-grade zinc values.

diversified, smaller firms, had increased substantially solely on the basis of the discovery of good anomalies or even because of the proximity of their lands to the situs of a potentially major strike.

Finally, a major factor in determining whether the K-55-1 Discovery was a material fact is the importance attached to the drilling results by those who knew about it. In view of other unrelated recent developments favorably affecting TGS, participation by an informed person in a regular stock-purchase program, or even sporadic trading by an informed person, might lend only nominal support to the inference of the materiality of the K-55-1 discovery; nevertheless, the timing by those who knew of it of their stock purchases and their purchases of *short-term* calls—purchases in some cases by individuals who had never before purchased calls or even TGS stock—virtually compels the inference that the insiders were influenced by the drilling results. This insider trading activity, which surely constitutes highly pertinent evidence and the only truly objective evidence of the materiality of the K-55-1 discovery, was apparently disregarded by the court below in favor of the testimony of defendants' expert witnesses, all of whom "agreed that one drill core does not establish an ore body, much less a mine," 258 F. Supp. at 282-283. Significantly, however, the court below, while relying upon what these defense experts said the defendant insiders *ought* to have thought about the worth to TGS of the K-55-1 discovery, and finding that from November 12, 1963 to April 6, 1964 Fogarty, Murray, Holyk and Darke spent more than $100,000 in purchasing TGS stock and calls on that stock, made no finding that the insiders were motivated by any factor other than the extraordinary K-55-1 discovery when they bought their stock and their calls. No reason appears why outside investors, perhaps better acquainted with spec-

ulative modes of investment and with, in many cases, perhaps more capital at their disposal for intelligent speculation, would have been less influenced, and would not have been similarly motivated to invest if they had known what the insider investors knew about the K-55-1 discovery.

Our decision to expand the limited protection afforded outside investors by the trial court's narrow definition of materiality is not at all shaken by fears that the elimination of insider trading benefits will deplete the ranks of capable corporate managers by taking away an incentive to accept such employment. Such benefits, in essence, are forms of secret corporate compensation, see Cary, Corporate Standards and Legal Rules, 50 Calif. L. Rev. 408, 409-10 (1962), derived at the expense of the uninformed investing public and not at the expense of the corporation which receives the sole benefit from insider incentives. Moreover, adequate incentives for corporate officers may be provided by properly administered stock options and employee purchase plans of which there are many in existence. In any event, the normal motivation induced by stock ownership, i.e., the identification of an individual with corporate progress, is ill-promoted by condoning the sort of speculative insider activity which occurred here; for example, some of the corporation's stock was sold at market in order to purchase short-term calls upon that stock, calls which would never be exercised to increase a stockholder equity in TGS unless the market price of that stock rose sharply.

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,—which market risks include, of course the risk that one's evaluative capacity or one's capital available to put

at risk may exceed another's capacity or capital. The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event such a major strike should materialize, but would decline little, if at all, in the event of failure, for the public, ignorant at the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.

We hold, therefore, that all transactions in TGS stock or calls by individuals apprised of the drilling results[14] of K-55-1 were made in violation of Rule 10b-5.[15] Inasmuch as the visual evaluation of that drill core (a generally reliable estimate though less accurate than a chemical assay) constituted material information, those advised of the results of the visual evaluation as well as those informed of the chemical assay traded in violation of law. The geologist Darke possessed undisclosed material information and

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14 The trial court found that defendant Murray "had no detailed knowledge as to the work" on the Kidd-55 segment. There is no evidence in the record suggesting that Murray purchased his stock on January 8, 1964, on the basis of material undisclosed information, and the disposition below is undisturbed as to him.

15 Even if insiders were in fact ignorant of the broad scope of the Rule and acted pursuant to a mistaken belief as to the applicable law such an ignorance does not insulate them from the consequences of their acts. *Tager* v. *SEC*, 344 F. 2d 5, 8 (2 Cir. 1965).

traded in TGS securities. Therefore we reverse the dismissal of the action as to him and his personal transactions. The trial court also found, 258 F. Supp. at 284, that Darke, after the drilling of K-55-1 had been completed and with detailed knowledge of the results thereof, told certain outside individuals that TGS "was a good buy." These individuals thereafter acquired TGS stock and calls. The trial court also found that later, as of March 30, 1964, Darke not only used his material knowledge for his own purchases but that the substantial amounts of TGS stock and calls purchased by these outside individuals on that day, see footnote 4, *supra,* was "strong circumstantial evidence that Darke must have passed the word to one or more of his 'tippees' that drilling on the Kidd 55 segment was about to be resumed." 258 F. Supp. at 284. Obviously if such a resumption were to have any meaning to such "tippees," they must have previously been told of K-55-1.

Unfortunately, however, there was no definitive resolution below of Darke's liability in these premises for the trial court held as to him, as it held as to all the other individual defendants, that this "undisclosed information" never became material until April 9. As it is our holding that the information acquired after the drilling of K-55-1 was material, we, on the basis of the findings of direct and circumstantial evidence on the issue that the trial court has already expressed, hold that Darke violated Rule 10b-5(3) and Section 10(b) by "tipping" and we remand, pursuant to the agreement of the parties, for a determination of the appropriate remedy.[16] As Darke's "tippees" are not defen-

16 Judges Waterman and Anderson, believing that there had been no definitive finding below as to whether Darke, expressly or by implication, transmitted to these outsiders any indication of the extremely favorable results of the drilling operation in which he was engaged, would remand

dants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible.

With reference to Huntington, the trial court found that he "had no detailed knowledge as to the work" on the Kidd-55 segment, 258 F. Supp. 281. Nevertheless, the evidence shows that he knew about and participated in TGS's land acquisition program which followed the receipt of the K-55-1 drilling results, and that on February 26, 1964 he purchased 50 shares of TGS stock. Later, on March 16, he helped prepare a letter for Dr. Holyk's signature in which TGS made a substantial offer for lands near K-55-1, and on the same day he, who had never before purchased calls on any stock, purchased a call on 100 shares of TGS stock. We are satisfied that these purchases in February and March, coupled with his readily inferable and probably reliable, understanding of the highly favorable nature of preliminary operations on the Kidd segment, demonstrate that Huntington possessed material inside information such as to make his purchase violative of the Rule and the Act.

C. *When May Insiders Act?*

Appellant Crawford, who ordered[17] the purchase of TGS stock shortly before the TGS April 16 official announce-

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for a determination on this issue, and if it should be determined that Darke did make such revelations, for a determination of the appropriate remedy.

17 The effective protection of the public from insider exploitation of advance notice of material information requires that the time that an insider places an order, rather than the time of its ultimate execution, be determinative for Rule 10b-5 purposes. Otherwise, insiders would

ment, and defendant Coates, who placed orders with and communicated the news to his broker immediately after the official announcement was read at the TGS-called press conference, concede that they were in possession of material information. They contend, however, that their purchases were not proscribed purchases for the news had already been effectively disclosed. We disagree.

Crawford telephoned his orders to his Chicago broker about midnight on April 15 and again at 8:30 in the morning of the 16th, with instructions to buy at the opening of the Midwest Stock Exchange that morning. The trial court's finding that "he sought to, and did, 'beat the news,'" 258 F. Supp. at 287, is well documented by the record. The rumors of a major ore strike which had been circulated in Canada and, to a lesser extent, in New York, had been disclaimed by the TGS press release of April 12, which significantly promised the public an official detailed announcement when possibilities had ripened into actualities. The abbreviated announcement to the Canadian press at 9:40 A.M. on the 16th by the Canadian Minister of Mines and the report carried by *The Northern Miner,* parts of which had sporadically reached New York on the morning of the 16th through reports from Canadian affiliates to a few New York investment firms, are assuredly not the equivalent of the official 10-15 minute announcement which was not released to the American financial press until after 10:00 A.M. Crawford's orders had been placed before that. Be-

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be able to "beat the news," cf. Fleischer, *supra,* 51 Va. L. Rev. at 1291, by requesting in advance that their orders be executed immediately after the dissemination of a major news release but before outsiders could act on the release. Thus it is immaterial whether Crawford's orders were executed before or after the announcement was made in Canada (9:40 A.M., April 16) or in the United States (10:00 A.M.) or whether Coates's order was executed before or after the news appeared over the Merrill Lynch (10:29 A.M.) or Dow Jones (10:54 A.M.) wires.

fore insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public. Particularly here, where a formal announcement to the entire financial news media had been promised in a prior official release known to the media, all insider activity must await dissemination of the promised official announcement.

Coates was absolved by the court below because his telephone order was placed shortly before 10:20 A.M. on April 16, which was after the announcement had been made even though the news could not be considered already a matter of public information. 258 F. Supp. at 288. This result seems to have been predicated upon a misinterpretation of dicta in *Cady, Roberts,* where the SEC instructed insiders to "keep out of the market until the established procedures for public release of the information are *carried out* instead of hastening to execute transactions in advance of, and in frustration of, the objectives of the release," 40 SEC at 915 (emphasis supplied). The reading of a news release, which prompted Coates into action, is merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments. Assuming that the contents of the official release could instantaneously be acted upon,[18] at the minimum

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18 Although the only insider who acted after the news appeared over the Dow Jones broad tape is not an appellant and therefore we need not discuss the necessity of considering the advisability of a "reasonable waiting period" during which outsiders may absorb and evaluate disclosures, we note in passing that, where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination. In any event, the permissible timing of insider transactions after disclosures of various sorts is one of the many areas of expertise for appropriate exercise of the SEC's rule-making power, which we hope will be utilized in the future to provide some predictability of certainty for the business community.

Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law.[19]

D. *Is An Insider's Good Faith A Defense Under 10b-5?*

Coates, Crawford and Clayton, who ordered purchases before the news could be deemed disclosed, claim, nevertheless, that they were justified in doing so because they honestly believed that the news of the strike had become public at the time they placed their orders. However, whether the case before us is treated solely as an SEC enforcement proceeding or as a private action,[20] proof of a specific intent to defraud is unnecessary. In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful. See *Berko* v. *SEC*, 316 F. 2d 137, 141-42 (2 Cir.

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19 The record reveals that news usually appears on the Dow Jones broad tape 2-3 minutes after the reporter completes dictation. Here, assuming that the Dow Jones reporter left the press conference as early as possible, 10:10 A.M., the 10-15 minute release (which took at least that long to dictate) could not have appeared on the wire before 10:22, and for other reasons unknown to us did not appear until 10:54. Indeed, even the abbreviated version of the release reported by Merrill Lynch over its private wire did not appear until 10:29. Coates, however, placed his call no later than 10:20.

20 The SEC seeks permanent injunctions restraining future proscribed activity by all the individual defendants and the corporation. The Commission also seeks court orders upon certain of the individual defendants that are essentially remedies of a private, rather than of a regulatory nature, court orders designed to have those individual defendants disgorge any profits they enjoyed from TGS stock transactions they or their "tippees" engaged in from November 12, 1963 to April 17, 1964.

1963); *SEC* v. *Capital Gains Bureau,* 375 U. S. 180, 193 (1963). A similar standard has been adopted in private actions, see, *e.g., Stevens* v. *Vowell,* 343 F. 2d 374 (10 Cir. 1965); *Ellis* v. *Carter,* 291 F. 2d 270 (9 Cir. 1961); *Royal Air Properties, Inc.* v. *Smith,* 312 F. 2d 210 (9 Cir. 1962); *Dack* v. *Shanman,* 227 F. Supp. 26 (SDNY 1964); but see, *e.g., Weber* v. *C. M. P. Corp.,* 242 F. Supp. 321 (SDNY 1965); *Thiele* v. *Shields,* 131 F. Supp. 416 (SDNY 1955), for policy reasons which seem perfectly consistent with the broad Congressional design " . . . to insure the maintenance of fair and honest markets in . . . [securities] transactions." Sec. 2 of SEC Act, 15 U. S. C. §78b, see *Kohler* v. *Kohler Co.,* 319 F. 2d 634, 642 (7 Cir. 1963); Note, 32 U. Chi. L. Rev. 824, 839-44 (1965); Note, 63 Mich. L. Rev. 1070, 1079-81 (1965).

Absent any clear indication of a legislative intention to require a showing of specific fraudulent intent, see Note, 63 Mich. L. Rev. 1070, 1075, 1076 n. 29 (1965), the securities laws should be interpreted as an expansion of the common law[21] both to effectuate the broad remedial design of Congress, see *SEC* v. *Capital Gains Research Bureau, supra* at 195, and to insure uniformity of enforcement, see Note, 32 U. Chi. L. Rev. 824, 832 n. 36 (1965), citing *McClure* v. *Borne Chemical Co.,* 292 F. 2d 824, 834 (3 Cir. 1961). Moreover, a review of other sections of the Act from which Rule 10b-5 seems to have been drawn suggests that the implementation of a standard of conduct that encompasses

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21 Even at common law, the essentially private remedy of rescission which is sought here does not require more than a showing of negligence and frequently even less than that, see Restatement, Contracts, §476, com b (1932); and the common law concept of constructive fraud still available to private plaintiffs, see *Trussell* v. *United Underwriters, Ltd.,* 228 F. Supp. 757, 772 (D. Colo. 1964), has been expanded from recklessness, see Prosser, Torts, §102 p. 715-17 (3d ed. 1964), to include non-reckless negligent misrepresentations or omissions, see Note, 63 Mich. L. Rev. 1070, 1079.

negligence as well as active fraud comports with the administrative and the legislative purposes underlying the Rule.[22] Finally, we note that this position is not, as asserted by defendants, irreconcilable with previous language in this circuit because "*some form* of the traditional scienter requirement," *Barnes* v. *Osofsky*, 373 F. 2d 269, 272 (2 Cir. 1967), (emphasis supplied), sometimes defined as "fraud," *Fischman* v. *Raytheon Mfg. Co.*, 9 F. R. D. 707 (SDNY 1949), *rev'd on other grounds*, 188 F. 2d 783, 786 (2 Cir. 1951) is preserved. This requirement, whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule.

Thus, the beliefs of Coates, Crawford and Clayton that the news of the ore strike was sufficiently public at the time of their purchase orders are to no avail if those beliefs were no reasonable under the circumstances. Crawford points to the scattered rumors of the discovery which had been circulating for some time before April 15, to the release of the information to *The Northern Miner* on April

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22 Liability under §12(2) of the Securities Act of 1933, 15 U. S. C. §77*l*(2), the language of which is strikingly similar to that of 10b-5(2), attaches from the mere fact of misrepresentation or misleading omission unless defendant proves that "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." The provisions of Sections 17(a)(2) and (3) of the Securities Act of 1933, 15 U. S. C. §77q(a)(2) and (3), which are virtually identical to the provisions of Rule 10b-5(2) and (3) and were, in fact, the model therefor, see *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461, 463 (2 Cir.), cert. denied, 343 U. S. 956 (1952); *Hooper* v. *Mountain States Sec. Corp.*, 282 F. 2d 195, 201 n. 4 (5 Cir. 1960), cert. denied, 365 U. S. 814 (1961), apply criminal penalties to sellers only (Rule 10b-5 was promulgated to fill this gap in enforcement, SEC Ann. Rep. 10 (1942)), and have been read, upon close scrutiny of their legislative history, as not requiring specific fraudulent intent, *SEC* v. *Van Horn*, 371 F. 2d 181, at 184-186 (7 Cir. 1966); *United States* v. *Schaefer*, 299 F. 2d 625, 629 (7 Cir. 1962) (lack of diligence is all that is required for conviction in a criminal prosecution for violation of §17(a) of the 1933 Act.

15 to be published by it on the 16th, to the arrangement made by TGS with the Ontario Minister of Mines for the release of an abbreviated report on the evening of the 15th (which did not eventuate until 9:40 A.M., April 16), and to the corporation's official announcement at 10:00 A.M. on the 16th, all of which transpired prior to an anticipated execution of his purchase orders that had been placed by him after trading had closed on the Midwest Exchange on April 15. However, the rumors and casual disclosure through Canadian media, especially in view of the April 12 gloomy or incomplete release denying the rumors and promising official confirmation, hardly sufficed to inform traders on American exchanges affected by Crawford's purchases. Moreover, the formal announcement could not reasonably have been expected to be disseminated by the time of the opening of the exchanges on the morning of April 16, when Crawford must have expected his orders would be executed.

Clayton, who was unaware of the April 16 disclosure announcement TGS was to make can, in support of his claim that the favorable news was public, rely only on the rumors and on the phone calls received by TGS prior to the placing of his order from those who seemed to have heard some version or rumors of the news. His awareness of the contents of the April 12 release renders unreasonable any claim that he believed the news was truly public.

Finally, Coates, as we have already indicated in fn. 19, *supra,* could not reasonably have expected the official release to have been disseminated when he placed his order before 10:20 for immediate execution nor were the Canadian disclosures relied on by Crawford sufficient to render the conduct of Coates permissible under the circumstances.[23]

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23 Coates's violations encompass not only his own purchases but also the purchases by his son-in-law and the customers of his son-in-law, to whom the material information was passed. See footnote 16, *supra.*

E. *May Insiders Accept Stock Options Without Disclosing Material Information To The Issuer?*

On February 20, 1964, defendants Stephens, Fogarty, Mollison, Holyk and Kline accepted stock options issued to them and a number of other top officers of TGS, although not one of them had informed the Stock Option Committee of the Board of Directors or the Board of the results of K-55-1, which information we have held was then material. The SEC sought rescission of these options. The trial court, in addition to finding the knowledge of the results of the K-55 discovery to be immaterial, held that Kline had no detailed knowledge of the drilling progress and that Holyk and Mollison could reasonably assume that their superiors, Stephens and Fogarty, who were directors of the corporation, would report the results if that was advisable; indeed all employees had been instructed not to divulge this information pending completion of the land acquisition program, 258 F. Supp. at 291. Therefore, the court below concluded that only directors Stephens and Fogarty, of the top management, would have violated the Rule by accepting stock options without disclosure, but it also found that they had not acted improperly as the information in their possession was not material. 258 F. Supp. at 292. In view of our conclusion as to materiality we hold that Stephens and Fogarty violated the Rule by accepting them. However, as they have surrendered the options and the corporation has canceled them, *supra* at 292, n. 17, we find it unnecessary to order that the injunctions prayed for be actually issued. We point out, nevertheless, that the surrender of these options after the SEC commenced the case is not a satisfaction of the SEC claim, and a determination as to whether the issuance of injunctions against Stephens and Fogarty is advisable in order to prevent or deter future violations of regulatory provi-

sions is remanded for the exercise of discretion by the trial court.

Contrary to the belief of the trial court that Kline had no duty to disclose his knowledge of the Kidd project before accepting the stock option offered him, we believe that he, a vice president, who had become the general counsel of TGS in January 1964, but who had been secretary of the corporation since January 1961, and was present in that capacity when the options were granted, and who was in charge of the mechanics of issuance and acceptance of the options, was a member of top management and under a duty before accepting his option to disclose any material information he may have possessed, and, as he did not disclose such information to the Option Committee we direct rescission of the option he received.[24] As to Holyk and

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24 The options granted on February 20, 1964 to Mollison, Holyk, and Kline were ratified by the Texas Gulf directors on July 15, 1965 after there had been, of course, a full disclosure and after this action had been commenced. However, the ratification is irrelevant here, for we would hold with the district court that a member of top management, as was Kline, is required, before accepting a stock option, to disclose material inside information which, if disclosed, might affect the price of the stock during the period when the accepted option could be exercised. Kline had known since November 1962 that K-55-1 had been drilled, that the drilling had intersected a sulphide body containing copper and zinc, and that TGS desired to acquire adjacent property.

Of course, if any of the five knowledgeable defendants had rejected his option there might well have been speculation as to the reason for the rejection. Therefore, in a case where disclosure to the grantors of an option would seriously jeopardize a corporate security, it could well be desirable, in order to protect a corporation from selling securities to insiders who are in a position to appreciate their true worth at a price which may not accurately reflect the true value of the securities and at the same time to preserve when necessary the secrecy of corporate activity, not to require that an insider possessed of undisclosed material information reject the offer of a stock option, but only to require that he abstain from exercising it until such time as there shall have been a full disclosure and, after the full disclosure, a ratification such as was voted here. However, as this suggestion was not presented to us, we do not consider it or make any determination with reference to it.

Mollison, the SEC has not appealed the holding below that they, not being then members of top management (although Mollison was a vice president) had no duty to disclose their knowledge of the drilling before accepting their options. Therefore, the issue of whether, by accepting, they violated the Act, is not before us, and the holding below is undisturbed.

II. The Corporate Defendant

Introductory

At 3:00 P.M. on April 12, 1964, evidently believing it desirable to comment upon the rumors concerning the Timmins project, TGS issued the press release quoted in pertinent part in the text at pages 3600-3601, *supra*. The SEC argued below and maintains on this appeal that this release painted a misleading and deceptive picture of the drilling progress at the time of its issuance, and hence violated Rule 10b-5(2).[25] TGS relies on the holding of the court below that "The issuance of the release produced no unusual market action" and "In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or Rule 10b-5 since it was not issued 'in connection with the purchase or sale of any security'" and, alternatively, "even if it had been established that the April 12 release was issued in connec-

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25 Rule 10b-5(2) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, . . .
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, . . .
>
> in connection with the purchase or sale of any security.

tion with the purchase or sale of any security, the Commission has failed to demonstrate that it was false, misleading or deceptive." 258 F. Supp. at 294.

Before further discussing this matter it seems desirable to state exactly what the SEC claimed in its complaint and what it seeks. The specific SEC allegation in its complaint is that this April 12 press release ". . . was materially false and misleading and was known by certain of defendant Texas Gulf's officers and employees, including defendants Fogarty, Mollison, Holyk, Darke and Clayton, to be materially false and misleading."

The specific relief the SEC seeks is, pursuant to Section 21(e) of Securities Exchange Act of 1934, 15 U. S. C. §78u(e), a permanent injunction restraining the issuance of any further materially false and misleading publicly distributed informative items.[26]

B. *The "In Connection With . . . Requirement.*

In adjudicating upon the relationship of this phrase to the case before us it would appear that the court below used a standard that does not reflect the congressional purpose that prompted the passage of the Securities Exchange Act of 1934.

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26 The prayer for relief reads:

WHEREFORE the plaintiff prays for:

* * * * *

(5) The issuance of a final judgment permanently enjoining the defendant Texas Gulf from directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, in connection with the purchase or sale of securities, making any untrue statement of material fact or omitting to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, namely, from issuing, publishing, distributing or otherwise disseminating materially false, misleading, inadequate or inaccurate press releases and other communications and reports concerning material facts about Texas Gulf's activities and operations.

The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading, including, specifically, inequities that follow from trading that has been stimulated by the publication of false or misleading corporate information releases. Commenting on the disclosure purposes of the House bill (H. R. 9323), the bill a Committee of Conference eventually integrated with a similar Senate bill (S. 3420) to make the bill passed by both Houses of Congress that became the Securities Exchange Act of 1934, the House Committee which reported out H. R. 9323 stated:

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. *There cannot be honest markets without honest publicity.* Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug

> of conflicting interests and the influence of popular groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of *true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges.* Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet. (Emphasis supplied.) H. R. Rep. No. 1383, 73rd Cong., 2d Sess. 11 (1934).

Section 10b of the Act (see footnote 8, *supra*) was taken by the Conference Committee from Section 10b of the proposed Senate bill, S. 3420, and taken from it verbatim insofar as here pertinent. The only alteration made by the Conference Committee was to substitute the present closing language of Section 10b, ". . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors" for the closing language of the original Section 10b of S. 3420, ". . . which the Commission may declare to be detrimental to the interests of investors." 78 Cong. Rec. 10261 (1934).

The Report of the Senate Committee which presented S. 3420 to the Senate summarized Section 10b as follows:

> Subsection (b) authorizes the Commission by rules and regulations to prohibit or regulate the use of *any other manipulative or deceptive practices which it finds detrimental to the interests of the investor.* (Emphasis supplied.)
>
> S. Rep. No. 792, 73rd Cong., 2d Sess. 18 (1934).

Indeed, from its very inception, Section 10(b), and the proposed sections in H. R. 1383 and S. 3420 from which it was derived, have always been acknowledged as catch-alls. See Bromberg, Securities Law: SEC Rule 10b-5, p. 19 (1967). In the House Committee hearings on the proposed House bill, Thomas G. Corcoran, Counsel with the Reconstruction Finance Corporation and a spokesman for the Roosevelt Administration, described the broad prohibitions contained in §9(c), the section which corresponded to Section 10(b) of S. 3420 and eventually to Section 10(b) of the Act, as follows: "Subsection (c) says, 'Thou shalt not devise any other cunning devices' . . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices." Stock Exchange Regulation, Hearings before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 2d Sess. 115 (1934). Although several other witnesses objected to the breadth of the proposed prohibition that Corcoran was supporting, the section as enacted did not in any way limit the broad scope of the "in connection with" phrase. See 3 Loss, Securities Regulation, 1424 n. 7 (2d ed. 1961).

Thus, the legislative history of Section 10(b) does not support the proposition urged upon us by Texas Gulf Sulphur that Congress intended the limited construction of the "in connection with" phrase applied by the trial court.

Moreover, comparisons of Section 10(b) with the antifraud provisions of the Securities Act of 1933 (§12(2), 15 U. S. C. §77*l*(2) "... [offers or] sells a security by means of ..."; §17(a), 15 U. S. C. §77q(a) "... in the [offer or] sale of any securities to obtain money or property by means of ..."; [language in brackets was added in 1954 amendments]), and with the 1936 antifraud amendment of Section 15 of the Securities Exchange Act of 1934 (§15(c)(1), 15 U. S. C. §78*o*(c)(1) "... effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security ...") demonstrate that when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear. See Bromberg, *op. cit. supra* Table 1 at 16-17.

Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with a purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives; indeed, the obvious purposes of the Act to protect the investing public and to secure fair dealing in the securities markets would be seriously undermined by applying such a gloss onto the legislative language. Absent a securities transaction by an insider it is almost impossible to prove that a wrongful purpose moti-

vated the issuance of the misleading statement. The mere fact that an insider did not engage in securities transactions does not negate the possibility of wrongful purpose; perhaps the market did not react to the misleading statement as much as was anticipated or perhaps the wrongful purpose was something other than the desire to buy at a low price or sell at a high price. Of even greater relevance to the Congressional purpose of investor protection is the fact that the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose. We do not believe that Congress intended that the proscriptions of the Act would not be violated unless the makers of a misleading statement also participated in pertinent securities transactions in connection therewith, or unless it could be shown that the issuance of the statement was motivated by a plan to benefit the corporation or themselves at the expense of a duped investing public.

Nor is there anything about Rule 10b-5 which demonstrates that the SEC sought by the Rule not fully to implement the Congressional purpose and objectives underlying Section 10(b). See Securities Exchange Act of 1934, Release No. 3230 (May 21, 1942); 10 SEC Ann. Rep. 56-7 (1944); 8 SEC Ann. Rep. 10 (1942). To be sure, SEC official publicity accompanying the promulgation of the Rule emphasized the insider trading aspects of the Rule, particularly the prohibition against purchases by insiders, but this was emphasized because "the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers," 8 SEC Ann. Rep. 10, and the Commission wished to make it emphatically clear that the Rule was expected, *inter alia,* to close this loophole.

The foregoing discussion demonstrates that Congress intended to protect the investing public in connection with their purchases or sales on Exchanges from being misled by misleading statements promulgated for or on behalf of corporations irrespective of whether the insiders contemporaneously trade in the securities of that corporation and irrespective of whether the corporation or its management have an ulterior purpose or purposes in making an official public release. Indeed, the Commission has been charged by Congress with the responsibility of policing all misleading corporate statements from those contained in an initial prospectus to those contained in a notice to stockholders relative to the need or desirability of terminating the existence of a corporation or of merging it with another. To render the Congressional purpose ineffective by inserting into the statutory words the need of proving, not only that the public may have been misled by the release, but also that those responsible were actuated by a wrongful purpose when they issued the release, is to handicap unreasonably the Commission in its work. We should have in mind the wise words of Judge Learned Hand in *Cawley* v. *United States,* 272 F. 2d 443, 445 (2 Cir. 1959), relative to an interpretation of the words contained within a congressional statute, that " . . . unless they explicitly forbid it, the purpose of a statutory provision is the best test of the meaning of the words chosen. We are to put ourselves so far as we can in the position of the legislature that uttered them, and decide whether or not it would declare that the situation that has arisen is within what it wishes to cover. Indeed, at times the purpose may be so manifest as to override even the explicit words used. *Markham* v. *Cabell,* 326 U. S. 404."

As was pointed out by the trial court, 258 F. Supp. at 293, the intent of the Securities Exchange Act of 1934 is

the protection of investors against fraud. Therefore, it would seem elementary that the Commission has a duty to police management so as to prevent corporate practices which are reasonably likely fraudulently to injure investors. And, of course, as we have already emphasized, a corporation's misleading material statement may injure an investor irrespective of whether the corporation itself, or those individuals managing it, are contemporaneously buying or selling the stock of the corporation. Therefore, when materially misleading corporate statements or deceptive insider activities have been uncovered, the courts, as they should, have broadly construed the statutory phrase "in connection with the purchase or sale of any security." *Freed* v. *Szabo Food Serv., Inc.*, CCH Fed. SEC L. Rep. ¶91,317 (N. D. Ill. 1964); *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (SDNY 1965); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (SDNY 1964); *Miller* v. *Bargain City, U. S. A., Inc.*, 229 F. Supp. 33, 37 (E. D. Pa. 1964); see Ruder, Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur, 61 Nw. U. L. Rev. 872, 895 (1967). The court below found: "There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage." 258 F. Supp. at 294. The requirement that a statement may not be found misleading unless its issuance is actuated by a "wrongful purpose" might well have the effect of permitting the issuers of misleading statements to seek an advantage but to escape liability if the advantage fails to materialize to the degree contemplated, or cannot be demonstrated.

More important, however, is the realization which we must again underscore at the risk of repetition, that the investing public is hurt by exposure to false or deceptive

statements irrespective of the purpose underlying their issuance.[27] It does not appear to be unfair to impose upon corporate management a duty to ascertain the truth of any statements the corporation releases to its shareholders or to the investing public at large. Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media, Fleischer, *supra,* 51 Va. L. Rev. at 1294-95, if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated.

C. *Did the Issuance of the April 12 Release Violate Rule 10b-5?*

Turning first to the question of whether the release was misleading, i.e., whether it conveyed to the public a false impression of the drilling situation at the time of its issuance, we note initially that the trial court did not actually decide this question. Its conclusion that "the Commission has failed to demonstrate that it was false, misleading or deceptive," 258 F. Supp. at 294, seems to have derived from its views that "The defendants are to be judged *on the facts known to them* when the April 12 release was issued," 258 F. Supp. at 295 (emphasis supplied), that the draftsmen "exercised reasonable business judgment under the

27 See the discussion in footnotes 20, 21, and 22, *supra,* and in the accompanying text, dispensing with a fraudulent intent requirement in actions based on clause (3) of Rule 10b-5.

circumstances," 258 F. Supp. at 296, and that the release was not "misleading or deceptive *on the basis of the facts then known,*" 258 F. Supp. at 296 (emphasis supplied) rather than from an appropriate primary inquiry into the meaning of the statement to the reasonable investor and its relationship to truth. While we certainly agree with the trial court that "in retrospect, the press release may appear gloomy or incomplete," [28] 258 F. Supp. at 296, we

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28 Examined in retrospect, the situation in Timmins at the time the release was prepared seems to offer good reason for optimism. The draftsmen of the release had full knowledge of the discoveries up to 7:00 P.M. on Friday, April 10. At that time approximately 2/3 of the ore ultimately found to exist by the time of the preparation of the April 16 "major strike" release had been discovered by 5 holes placed so as to indicate continuity of mineralization within the large anomaly. As of that time SEC experts estimated ore reserves of over 8 million tons at a gross assay value (excluding costs) of over $26 a ton. Accepting the conservative view of TGS's expert Wiles that 95.2% would be absorbed by costs, the ultimate profit could then have been estimated at more than $14,000,000. TGS experts could name very few base metal mines with a greater assay value and the court observed that bodies of much lower assay value were commercially mined, 258 F. Supp. at 282 n. 10. Roche, a mining stock specialist, added that mines with significantly lower percentages of copper and with no zinc or silver, as here, were profitably operated. On the basis of approximately one-third more data, and, for all the record shows, without any additional figures as to estimated costs, TGS announced on April 16 a major strike with over 25 million tons of ore. The trial court found that as of 7:00 P.M. on Thursday, April 9, "There was real evidence that a body of commercially mineable ore might exist." 252 F. Supp. at 282. And, by 7:00 A.M. on Sunday, April 10, eight hours before the release was issued to the press, 77.9% of the drilling in mineralization had been completed, 84.4% by 7:00 P.M. on the 12th, and 90.2% by 7 A.M. on April 13. The release did not appear in most newspapers of general circulation until later in the morning of Monday, the 13th.

The release, see pp. 3600-3601 *supra*, began by referring to rumored reports that the company had made a substantial copper discovery and then continued: "These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS." It then stated, purporting to give the true facts in contradiction to the rumors: "The facts are as follows." However, the "facts" disclosed relative to the Kidd-55 segment were: "Recent drilling on one property near Timmins has led to preliminary

cannot, from the present record, by applying the standard Congress intended, definitively conclude that it was deceptive or misleading to the reasonable investor, or that he would have been misled by it. Certain newspaper accounts of the release viewed the release as confirming the existence of preliminary favorable developments, and this optimistic view was held by some brokers, so it could be that the reasonable investor would have read between the lines of what appears to us to be an inconclusive and negative statement and would have envisioned the actual situation at the Kidd segment on April 12. On the other hand, in view of the decline of the market price of TGS stock from a high of 32 on the morning of April 13 when the release was disseminated to 29⅜ by the close of trading on April 15, and the reaction to the release by other brokers, it is far from certain that the release was generally interpreted as a highly encouraging report or even encouraging at all. Accordingly, we remand this issue to the district court that took testimony and heard and saw the witnesses for a determination of the character of the release in the light of the facts existing at the time of the release, by applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it.

In the event that it is found that the statement was misleading to the reasonable investor it will then become necessary to determine whether its issuance resulted from a lack of due diligence. The only remedy the Commission seeks against the corporation is an injunction, see footnote 26,

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indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable." It was then said that, as of April 12, the release date, ". . . any statement as to size and grade of ore would be premature and possibly misleading." A definite statement "to clarify" was promised in the future.

supra, and therefore we do not find it necessary to decide whether just a lack of due diligence on the part of TGS, absent a showing of bad faith, would subject the corporation to any liability for damages. We have recently stated in a case involving a private suit under Rule 10b-5 in which damages and an injunction were sought, " 'It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.' " *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F. 2d 540, 547, quoting from *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U. S. 180, 193 (1963).

We hold only that, in an action for injunctive relief, the district court has the discretionary power under Rule 10b-5 and Section 10(b) to issue an injunction, if the misleading statement resulted from a lack of due diligence on the part of TGS. The trial court did not find it necessary to decide whether TGS exercised such diligence and has not yet attempted to resolve this issue. While the trial court concluded that TGS had exercised "reasonable *business* judgment under the circumstances," 258 F. Supp. at 296 (emphasis supplied) it applied an incorrect *legal* standard in appraising whether TGS should have issued its April 12 release on the basis of the facts known to its draftsmen at the time of its preparation, 258 F. Supp. at 295, and in assuming that disclosure of the full underlying facts of the Timmins situation was not a viable alternative to the vague generalities which were asserted. 258 F. Supp. at 296.

It is not altogether certain from the present record that the draftsmen could, as the SEC suggests, have readily obtained current reports of the drilling progress over the weekend of April 10-12, but they certainly should have obtained them if at all possible for them to do so. However, even if it were not possible to evaluate and transmit

current data in time to prepare the release on April 12, it would seem that TGS could have delayed the preparation a bit until an accurate report of a rapidly changing situation was possible. See 258 F. Supp. at 296. At the very least, if TGS felt compelled to respond to the spreading rumors of a spectacular discovery, it would have been more accurate to have stated that the situation was in flux and that the release was prepared as of April 10 information rather than purporting to report the progress "to date." Moreover, it would have obviously been better to have specifically described the known drilling progress as of April 10 by stating the basic facts. Such an explicit disclosure would have permitted the investing public to evaluate the "prospect" of a mine at Timmins without having to read between the lines to understand that preliminary indications were favorable—in itself an understatement.

The choice of an ambiguous general statement rather than a summary of the specific facts cannot reasonably be justified by any claimed urgency. The avoidance of liability for misrepresentation in the event that the Timmins project failed, a highly unlikely event as of April 12 or April 13, did not forbid the accurate and truthful divulgence of detailed results which need not, of course, have been accompanied by conclusory assertions of success. Nor is it any justification that such an explicit disclosure of the truth might have "encouraged the rumor mill which they were seeking to allay." 258 F. Supp. at 296.

We conclude, then, that, having established that the release was issued in a manner reasonably calculated to affect the market price of TGS stock and to influence the investing public, we must remand to the district court to decide whether the release was misleading to the reasonable investor and if found to be misleading, whether the court in its discretion should issue the injunction the SEC seeks.

Conclusion

In summary, therefore, we affirm the finding of the court below that appellants Richard H. Clayton and David M. Crawford have violated 15 U. S. C. §78j(b) and Rule 10b-5; we reverse the judgment order entered below dismissing the complaint against appellees Charles F. Fogarty, Richard H. Clayton, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Earl L. Huntington, and Francis G. Coates, as we find that they have violated 15 U. S. C. §78j(b) and Rule 10b-5. As to these eight individuals we remand so that in accordance with the agreement between the parties the Commission may notice a hearing before the court below to determine the remedies to be applied against them. We reverse the judgment order dismissing the complaint against Claude O. Stephens, Charles F. Fogarty, and Harold B. Kline as recipients of stock options, direct the district court to consider in its discretion whether to issue injunction orders against Stephens and Fogarty, and direct that an order issue rescinding the option granted Kline and that such further remedy be applied against him as may be proper by way of an order of restitution; and we reverse the judgment dismissing the complaint against Texas Gulf Sulphur Company, remand the cause as to it for a further determination below, in the light of the approach explicated by us in the foregoing opinion, as to whether, in the exercise of its discretion, the injunction against it which the Commission seeks should be ordered.

FRIENDLY, *Circuit Judge* (concurring):

Agreeing with the result reached by the majority and with most of Judge Waterman's searching opinion, I take a rather different approach to two facets of the case.

I.

The first is a situation that will not often arise, involving as it does the acceptance of stock options during a period when inside information likely to produce a rapid and substantial increase in the price of the stock was known to some of the grantees but unknown to those in charge of the granting. I suppose it would be clear, under *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2 Cir. 1964),[1] that if a corporate officer having such knowledge persuaded an unknowing board of directors to grant him an option at a price approximating the current market, the option would be rescindable in an action under Rule 10b-5. It would seem, by the same token, that if, to make the pill easier to swallow, he urged the directors to include others lacking the knowledge he possessed, he would be liable for all the resulting damage. The novel problem in the instant case is to define the responsibility of officers when a directors' committee

1 Since none of the parties has raised the question, I assume the continuing vitality of *Ruckle*, despite what have been regarded as contrary intimations in *O'Neill* v. *Maytag*, 339 F. 2d 764 (2 Cir. 1964), a decision that has not found favor with other circuits. Cf. *Dasho* v. *The Susquehanna Corp.*, 380 F. 2d 262 (7 Cir.), cert. denied, 381 U. S. 977 (1967); *Pappas* v. *Moss*, 393 F. 2d 865 (3 Cir. 1968); see Jennings, Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations under Rule 10b-5, 62 Nw. U. L. Rev. 809, 830-33 (1968). If we were writing on a clean slate, I would have some doubt whether the framers of the Securities Exchange Act intended §10b to provide a remedy for an evil that had long been effectively handled by derivative actions for waste of corporate assets under state law simply because in a particular case the waste took the form of a sale of securities. We will shortly be exploring this issue in the *in banc* consideration of *Schoenbaum* v. *Firstbrook*, slip opinions 2459.

administering a stock option plan proposes of its own initiative to make options available to them and others at a time when they know that the option price, geared to the market value of the stock, did not reflect a substantial increment likely to be realized in short order and was therefore unfair to the corporation.

A rule requiring a minor officer to reject an option so tendered would not comport with the realities either of human nature or of corporate life. If the SEC had appealed the ruling dismissing this portion of the complaint as to Holyk and Mollison, I would have upheld the dismissal quite apart from the special circumstance that a refusal on their part could well have broken the wall of secrecy it was important for TGS to preserve. Whatever they knew or didn't know about Timmins, they were entitled to believe their superiors had reported the facts to the Option Committee unless they had information to the contrary. Stephens, Fogarty and Kline stand on an altogether different basis; as senior officers they had an obligation to inform the Committee that this was not the right time to grant options at 95% of the current price. Silence, when there is a duty to speak, can itself be a fraud. I am unimpressed with the argument that Stephens, Fogarty and Kline could not perform this duty on the peculiar facts of this case, because of the corporate need for secrecy during the land acquisition program. Non-management directors would not normally challenge a recommendation for postponement of an option plan from the President, the Executive Vice President, and the Vice President and General Counsel. Moreover, it should be possible for officers to communicate with directors, of all people, without fearing a breach of confidence. Hence, as one of the foregoing hypotheticals suggests, I am not at all sure that a company in the position

of TGS might not have a claim against top officers who breached their duty of disclosure for the entire damage suffered as a result of the untimely issuance of options, rather than merely one for rescission of the options issued to them.[2] Since that issue is not before us, I merely make the reservation of my position clear.

II.

The second point, to me transcending in public importance all others in this important case, is the press release issued by TGS on April 12, 1964. This seems to me easier on the facts but harder on the law than it does to the majority.

No one has asserted, or reasonably could assert, that the purpose for issuing a release was anything but good. TGS felt it had a responsibility to protect would-be buyers of its shares from what it regarded as exaggerated rumors first in the Canadian and then in the New York City press, and none of the individual defendants sought to profit from the decline in the price of TGS stock caused by the release. I find it equally plain, as Judge Waterman's opinion convincingly demonstrates, that the release did not properly convey the information in the hands of the draftsmen on April 12, even granting, as I would, that in a case like this

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2 Though the Board of Directors of TGS ratified the issuance of the options after the Timmins discovery had been fully publicized, it obviously was of the belief that Kline had committed no serious wrong in remaining silent. Throughout this litigation TGS has supported the legality of the actions of all the defendants—the company's counsel having represented, among others, Stephens, Fogarty and Kline. Consequently, I agree with the majority in giving the Board's action no weight here. If a fraud of this kind may ever be cured by ratification, compare *Continental Securities* v. *Belmont*, 206 N. Y. 7 (1912), with *Claman* v. *Robertson*, 164 Ohio St. 61 (Sup. Ct. 1955); cf. *Wilko* v. *Swan*, 346 U. S. 427 (1953), that cannot be done without an appreciation of the illegality of the conduct proposed to be excused, cf. *United Hotels Co.* v. *Mealey*, 147 F. 2d 816, 819 (2 Cir. 1945).

a court should not set the standard of care too high. To say that the drilling at Timmins had afforded only "preliminary indications that more drilling would be required for proper evaluation of this prospect," was a wholly insufficient statement of what TGS knew. Cf. *Gediman* v. *Anheuser Busch, Inc.*, 299 F. 2d 537, 545 (2 Cir. 1962). Since the issue of negligence is open to full review, *Mamiye Bros.* v. *Barber SS. Lines,* 360 F. 2d 774 (2 Cir.), cert. denied, 385 U. S. 835 (1965); *Esso Standard Oil, S.A.* v. *S.S. Gasbras Sul,* 387 F. 2d 573 (2 Cir.), cert. denied, 36 L. W. 3443 (May 21, 1968), I see no need for a remand on that score. It is an equally needless exercise to require the district court to determine whether a reasonable investor would have been misled. The text of the release and the three point drop in the market price following its issuance in the face of press reports that would normally have led to a large and, as matters developed, justified increase, are sufficient proof of that.

The majority says that negligent misstatement by a corporation is enough for injunctive relief under Rule 10b-5 (2) in a proper case; it reserves the question, not here presented, whether the corporation is liable for damages. I think the remand should make crystal clear that the issue whether this is a proper case for an injunction remains open, and that with 49 private actions pending in the District Court for the Southern District of New York, see 258 F. Supp. 262, 267 n. 1 (1966), some of which may involve this issue, we should explicate more clearly why, despite the principle that a violation of the securities laws or regulations generally gives rise to a private claim for damages, see *J. I. Case Co.* v. *Borak,* 377 U. S. 426 (1964), violation of Rule 10b-5(2) may not do so under all circumstances, including those presented by the April 12 press release.

The attention this case has received from the profession and our *in banc* consideration make it incumbent on us to give the district courts in our circuit as much guidance as we can.

A.

The consequences of holding that negligence in the drafting of a press release such as that of April 12, 1964, may impose civil liability on the corporation are frightening. As has been well said, of a situation where time pressures and consequent risks were less, "One source of perplexity as to the appropriate bounds of the civil remedy for misleading filings is that any remedy imposed against the issuer itself is indirectly imposed on all holders of the common stock, usually the most important segment of the total category of investors intended to be protected." Milton Cohen, Truth in Securities Revisited, 79 Harv. L. Rev. 1340, 1370 (1967). Beyond this, a rule imposing civil liability in such cases would work directly counter to what the SEC has properly called "a commendable and growing recognition on the part of industry and the investment community of the importance of informing security holders and the public generally with respect to important business and financial developments." Securities Act Interpretation Release No. 3844 (Oct. 8, 1957). If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.

The derivation of Rule 10b-5 is peculiar. Although the authority for the Rule comes from §10b of the Securities

and Exchange Act of 1934, the draftsmen turned their backs on the language of that section and borrowed the words of §17 of the Securities Act of 1933, simply broadening these to include frauds on the seller as well as on the buyer. So far as concerns paragraphs (1) and (3), this is not very important since these are clearly within the ambit of §10b and relate to frauds that would give rise to civil liability in any event. But the case stands differently as to paragraph (2). The only provision in either the 1933 or the 1934 Act that can be read to impose liability for damages for negligent misrepresentation without restrictions as to the kinds of plaintiffs, due diligence defenses, a short statute of limitations, or an undertaking for costs that were insisted on by the investment community, is §17(a)(2) of the Act of 1933—the source of Rule 10b-5(2).[3] But there is unanimity among the commentators, including some who were in a peculiarly good position to know, that §17(a)(2) of the 1933 Act—indeed the whole of §17—was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§11 and 12. See Landis, Liability Sections of Securities Act, 18 Am. Acct. 330, 331 (1933); Douglas and Bates, Federal Securities Act of 1933, 43 Yale L. J. 171, 181-82 (1933); 3 Loss, Securities Regulation 1785-86 (1961). When the House Committee Report listed the sections that "define the civil liabilities imposed by the Act" it pointed only to §§11 and 12 and stated that "[t]o impose a greater responsibility [than that provided by §§11 and 12] . . . would unnecessarily restrain the conscientious administration of

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3 Of course, §12(1)'s imposition of a liability almost absolute upon the seller of a security that has not been registered in violation of §5 of the 1933 Act is grounded on distinctive concerns. See 3 Loss, Securities Regulation 1692-96 (1961).

honest business with no compensating advantage to the public." H. Rep. No. 85, 73d Cong., 1st Sess. 9-10 (1933). Once it had been established, however, that an aggrieved buyer has a private action under §10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under §17—with the important proviso that fraud, as distinct from mere negligence, must be alleged. See *Fischman* v. *Raytheon Mfg. Corp.*, 188 F. 2d 783, 787 n. 2 (2 Cir. 1951); *Weber* v. *C. M. P. Corp.*, 242 F. Supp. 321, 322-25 (S. D. N. Y. 1965) (Wyatt, *J.*); *Thiele* v. *Shields*, 131 F. Supp. 416, 419 (S. D. N. Y. 1955) (Kaufman, *J.*); but see *Dack* v. *Shanman*, 227 F. Supp. 26 (S. D. N. Y. 1964). To go further than this, as Professor Loss powerfully argues, Securities Regulation at 1785, would totally undermine the carefully framed limitations imposed on the buyer's right to recover granted by §12(2) of the 1933 Act.

Even if, however, we were to disregard the teaching of Judge Frank in *Fischman* v. *Raytheon Mfg. Corp.*, *supra*, 188 F. 2d at 786, and follow the lead of those Circuits that seem to have discarded the *scienter* requirement in actions for damages under Rule 10b-5,[4] *Ellis* v. *Carter*, 291 F. 2d 270, 274 (9 Cir. 1961); *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210, 212 (9 Cir. 1962); *Kohler* v. *Kohler Co.*, 208 F. Supp. 808, 823 (E. D. Wisc. 1962) (dictum), aff'd, 319 F. 2d 634 (7 Cir. 1962); *Stevens* v. *Vowell*, 343 F. 2d 374 (10 Cir. 1965); *Myzel* v. *Fields*, 386 F. 2d 718 (8 Cir. 1967);

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4 The imposition of liability on Clayton, Crawford and Coates for "beating the gun" does not require any such metamorphosis of Judge Frank's concept of fraud as the majority opinion seeks to perform. The only one of these defendants who came close to a showing of good faith was Coates. But even he did not act on the belief that the second press release had in fact reached the market, see 258 F. Supp. at 288; his defense was rather a belief that the law required him only to await its issuance. While such an erroneous view of the law is pardonable, it is not "good faith" in a legal sense.

we should not impose such expansive liability in a situation, markedly different from those considered in the cases just cited, where to do so would frustrate, not further, the larger goals of the securities laws. While I am not convinced that imposition of liability for damages under Rule 10b-5(2), absent a *scienter* requirement, even limited in the way just proposed, would not go beyond the authority vested in the Commission by §10b to act against "any manipulative or deceptive device or contrivance" and be so inconsistent with the general structure of the statutes as to be impermissible, it is at least clear that the April 12 press release would be the worst possible case for the award of damages for merely negligent misstatement, as distinguished from the kind of recklessness that is equivalent to wilful fraud, see *SEC* v. *Frank,* 388 F. 2d 486, 489 (2 Cir. 1968).

The issue here, however, is the different one of an injunction. Mr. Justice Goldberg noted in *SEC* v. *Capital Gains Research Bureau,* 375 U. S. 180, 193 (1963), that the elements of a cause of action for "fraud" vary "with the nature of the relief sought" and that "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for money damages." See also *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F. 2d 540, 547 (2 Cir. 1968). It can, indeed, be argued that, even on this basis, Rule 10b-5(2), absent the reading in of a *scienter* requirement, goes beyond the authority granted by §10b of the 1934 Act. However, it cannot be doubted that one of the most important purposes of the securities legislation was to prevent improper information being circulated by the issuer, and I therefore am not disposed to hold that Congress meant to deny a power whose use in appropriate cases can be of such great public benefit and do so little harm to legitimate activity.

B.

However, it does not necessarily follow that this is an appropriate case for granting an injunction as to future press releases. While we have often said that "a cessation of the alleged objectionable activities by the defendant in contemplation of an SEC suit will not defeat the district court's power to grant an injunction restraining continued activity," *SEC* v. *Boren,* 283 F. 2d 312 (2 Cir. 1960), and cases there cited, it is likewise true that an isolated violation, especially in the absence of bad faith, does not *require* such relief. *SEC* v. *Torr,* 87 F. 2d 446 (2 Cir. 1937). Absent much clearer language than is found in the 1934 Act, the entitlement of a plaintiff to an injunction thereunder remains subject to principles of equitable discretion. The Supreme Court made this clear beyond peradventure in the leading case of *Hecht Co.* v. *Bowles,* 321 U. S. 321 (1944). See 3 Loss, Securities Regulation 1975-83 (1961). Here there is no danger of repetition of an unduly gloomy press release like that of April 12. The essence of the SEC's case is that Timmins was a once-in-a-lifetime affair; the company's motive in issuing the release was laudable; and the defect was solely a pardonable one of execution. If Judge Bonsal had denied an injunction on these grounds, I see no basis on which we could properly have reversed him. Instead he acted on the view, erroneous in the court's belief, that no violation of the Rule had occurred and he was thus without power to enjoin, 259 F. Supp. 296. Although I see no reason why we could not affirm nevertheless, I am content to leave it for him to consider whether, although he has power to issue an injunction, there is equity in this portion of the bill. My concurrence in the disposition of the press release issue assumes that such consideration is permitted.

KAUFMAN, *Circuit Judge* (concurring):

I concur in Judge Waterman's reasoned and thorough opinion and in the court's disposition of the instant appeal. I agree with Judge Friendly, however, that we should provide guidance to the District Courts with respect to pending private claims for damages based upon Rule 10(b)(5) arising out of the transactions now before us. And, I concur in as much as Part II of Judge Friendly's opinion as discusses the origins of the rule and the relevance of today's decision —involving only an application by the S. E. C. for an injunction—to private damage actions.

ANDERSON, *Circuit Judge* (concurring):

I concur in Judge Waterman's majority opinion and I concur in the discussion of law set forth in Part II of Judge Friendly's concurring opinion.

HAYS, *Circuit Judge* (concurring in part and dissenting in part):

I concur generally with Judge Waterman in his views as to the proper interpretation of Section 10(b) and Rule 10b-5 and as to the standards which are to be employed in the application of the statute and the rule.

With the exception of Stephens and Fogarty as recipients of stock options, I agree with the majority on the disposition of the cases involving individuals.

I do not agree on the remand of the issue with respect to Stephens and Fogarty as recipients of stock options. It seems to me clear that the injunction sought by the Commission should be granted.

The majority remand the case against the corporate defendant to the district court for a determination as to

whether the April 12 press release was misleading and whether, if so, those responsible for the release used due diligence.

In my opinion the evidence establishes as a matter of law that the press release was misleading. Indeed, if the correct standard is applied, the finding of the trial court requires the conclusion that the press release was misleading:

> "At 7:00 p.m. on April 9, those with knowledge of the drilling results had material information which it was reasonably certain, if disclosed, would have had a substantial impact on the market price of TGS stock."

The evidence in the record in support of this finding is overwhelming.

Assuming arguendo that the corporation cannot be enjoined except on a showing of lack of due diligence, since Fogarty and those who assisted him in the preparation of the press release were aware of the drilling results to which the district court's finding refers, they obviously did not use due diligence in the preparation of the misleading press release.

I would grant the application for an injunction.

MOORE, *Circuit Judge* (dissenting) (with whom Chief Judge Lumbard concurs):

In their opinion, the majority have become so involved in usurping the function of the trial court, in selecting the witnesses they (at variance with the trial court) choose to believe, in forming their own factual conclusions from the evidence (in disregard of Rule 52a), in deciding with, of course, the benefit of the wisdom of hindsight, how they, had they been executives of Texas Gulf Sulphur Company (TGS), would have handled the publicity attendant to the

exploration of the Timmins property, in determining (to their own satisfaction) the motives which prompted each of the individual defendants to buy TGS stock and in becoming mining engineering experts in their own right, that I find it desirable—in fact, essential—to state my opinion as to the fundamental jurisdiction of the Court of Appeals and the issues properly before us. Primarily, our task should be to review errors of law. Conversely, we are not a jury of nine with no requirement of a unanimous verdict.

If the facts are to be reappraised by an appellate court, they should be measured *mutatis mutandis* in accordance with the standard set for himself by an experienced and learned trial judge who stated his approach in a case charging directors with wrongdoing, as follows:

> "The Court has endeavored * * * to judge the transactions in issue in this case by the applicable legal standards but without the benefit of hindsight as to the facts." (Herlands, *D.J., in Marco, etc.* v. *The Bank of New York, etc.*, 272 F. Supp. 636, 639 (S. D. N. Y., 1967).)

More, specifically, the Court in *Marco* said:

> "The Court is asked by plaintiff, in effect, to substitute its judgment for that of the directors with respect to transactions affecting the internal affairs of the corporation in question. * * * As directors they were, of course, required to perform their duties in accordance with the high standards of fidelity, honesty and prudence applicable to fiduciaries." (p. 639)

The Securities and Exchange Commission (referred to as the "SEC" and "Commission"), as an agency of government, has the responsibility of prosecuting persons who,

and corporations which, in its judgment have violated laws which the Congress has enacted for the praiseworthy purpose of protecting the public from securities frauds. However, as such an enforcement agency, where it assumes a plaintiff's role it must bear the evidentiary fair preponderance burden of all litigants and be subject to the rule that the determination of what evidence is "credible" is for the trial judge.

The Issues

The case logically and chronologically can be divided into two parts: (1) the purchase of TGS stock by individual defendants and stock options issued to them between November 12, 1963 and April 9, 1964, and (2) the TGS press release of April 12, 1964. The stock purchases by Clayton, Crawford and Coates on April 16, 1964, are considered later.

(1) In resolving the stock purchase issue, the primary factual inquiry must be concentrated on (a) the nature and extent of the knowledge possessed by, or available to, the purchaser on the date of purchase, and (b) the position of the purchaser in relation to TGS. The primary legal issue in substance is what duty, if any, rested upon the purchasers to disclose the knowledge they possessed at the time of purchase. The Commission argues that there was a failure to disclose material information. The trial court based its opinion largely upon the lack of materiality of such exploration results as were known between November 12, 1963 and April 9, 1964.

(2) Was the TGS press release of April 12, 1964, false, misleading or deceptive within the meaning of Section 10(b) and Rule 10b-5 in the light of TGS' then knowledge and the then existing factual situation.

The Facts

By-passing momentarily the general knowledge possessed by the officers of TGS as to the far-flung nature of the company's operations, its heavy concentration in the sulphur field, its non-engagement in the field of copper mining, the adverse effect which low sulphur prices had had for many years on the company's earnings despite substantial sales and focusing attention solely upon the Timmins property, the participants in that exploration and the knowledge available to them, I find no factual disputes of importance.

On November 8, 1963, TGS, selecting the most promising area of the one-quarter section then controlled by it, referred to as Kidd 55, drilled an exploratory hole, 1⅛ inches in diameter. All the information that was available upon the completion of the drilling, November 12, 1963, was contained in a core (denominated K-55-1) which was visually examined by Dr. Walter Holyk, Chief Geologist for TGS, and by Kenneth H. Darke, a TGS geologist. This core was unusually good in mineral content. The President, Claude O. Stephens, the Executive Vice-President, Charles F. Fogarty, and the Exploration Vice-President, Richard D. Mollison, were notified, and Fogarty and Mollison flew to the drill site.

In order to acquire the other three-quarters of the K-55 segment, further drilling was discontinued except for one hole drilled to produce a barren core and the site was camouflaged. Thus, but for a chemical assay made in December 1963 of contents of this same core, no other knowledge of the nature and possible extent of the area was available during the acquisition program.

Rule 52(a) should be given particular weight where expert testimony must of necessity play an important role. Here the trial court had an opportunity not only to hear

the qualifications of the experts but also from their demeanor and responses to form its opinion as to their credibility. The importance of this opportunity to observe where technical or scientific problems are before the court, as here, has been succinctly stated by the Supreme Court in *Graver Tank & Mfg. Co.* v. *Linde Air Prods. Co.*, 339 U. S. 605 (1950):

> "Like any other issue of fact, final determination requires a balancing of credibility, persuasiveness and weight of evidence. It is to be decided by the trial court and that court's decision, under general principles of appellate review, should not be disturbed unless clearly erroneous. Particularly is this so in a field where so much depends upon familiarity with specific scientific problems and principles not usually contained in the general storehouse of knowledge and experience." (pp. 609-610)
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> * * * * *
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> "It is not for this Court [the Supreme Court] to even essay an independent evaluation of this evidence. This is the function of the trial court. And, as we have heretofore observed, 'To no type of case is this . . . more appropriately applicable than to the one before us, where the evidence is largely the testimony of experts as to which a trial court may be enlightened by scientific demonstrations. * * *' 336 U. S. 271, 274-5." (p. 611)

No more is it for this court to make an independent essay of the evidence or of the core. Wanting the knowledge requisite to making our own appraisal of the significance of the core, we must depend upon the experts. A correct decision in this case may well hang upon their testimony

and its credibility because what these observers knew or should have known between November 12, 1963 and April 9, 1964 is basic to a determination of what, if anything, should have been disclosed or whether it was "material."

For the defendants, Dean Forrester, Dean of the College of Mines of the University of Arizona and Director of the Arizona Bureau of Mines, said that "one hole is evidence of what you encounter only in that hole" and that even after K-55-3 was drilled in April 1964, it was "much more likely that the materials exposed in those two holes will extend for, let's say, two feet outside the limits of the hole than it is likely that it will extend 25 feet or that it will extend 50 feet."

Dr. Park, former Dean of the School of Earth Sciences at Stanford, admitted that K-55-1 was "an interesting one, a good one" but that there was not "any evidence at all for any discussion of extent, from one drill hole." Dr. Lacy, head of the mining department of the University of Arizona, was of the opinion that "There is no basis for making any sort of prediction out from the hole."

Wiles, a consulting mining engineer, conceded that K-55-1 was a remarkable drill hole but that he could not estimate therefrom the probabilities of finding a commercially mineable body of ore, adding that he had had "the misfortune of having found a very attractive first hole and after drilling 52 around it got no more ore." Walkey, the manager of the Kamkotia, a mine some 12 miles distant from the Timmins property, testified that the geological composition of the Kamkotia and TGS areas was similar but that he could neither estimate nor say the chances were good of proving a substantial body of ore as a result of K-55-1.

Even the Commission's experts, Adelstein and Pennebaker, would not estimate what ore, if any, might lie beyond the 1⅛ inch core.

Adelstein:

"I think assay value given for a drill hole, standing by itself without surrounding information, cannot be interpreted by itself as to what it really means."

Pennebaker:

Q. You certainly couldn't compute any tonnage from that single hole, could you? A. No, sir.

Q. Nor could you compute any grade of ore beyond what was in the core itself? A. You are confined to what is in the core, sir.

[This witness did say that it was "inconceivable to expect the ore would quit immediately outside the drill hole, but you have no way of measuring how far it is going to go except the favorable implication of the anomaly."]

From this testimony, the trial court found:

"However, all the experts agreed that one drill core does not establish an ore body, much less a mine. Defendants' experts unanimously concluded that there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body." 258 F. Supp. at 282.

Despite the experts' virtually uncontradicted testimony, despite Rule 52(a) and despite the Supreme Court's statement of the law, the majority choose to reject the trial court's findings as to the results of the first drill core, K-55-1, and to substitute their own expertise in the mining engineering field by holding that "knowledge of the possibility which surely was more than marginal of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface (sug-

gesting mineability by the less expensive open-pit method) within the confines of a large anomaly (suggesting an extensive region of mineralization) might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell or hold."

Indeed, any such conclusions from a first drill core, if so announced by TGS, would undoubtedly have had a substantial effect on the market price of TGS stock and would have immediately brought forth both the wrath of, and injunction papers from, the Commission charging TGS with issuing false, misleading and unsupported statements to boost the price of the stock.

Factually, the premise posed by the majority is "clearly erroneous." There was no knowledge of the existence of a "mine." Even to the majority in their self-assumed fact-finding role, the "mine" was only a more than marginal "possibility." The testimony was unanimous that no estimate of "magnitude" could be made. The "large anomaly" did not suggest "an extensive region of mineralization" and furthermore TGS did not own or control it in any event. Its area was then limited to its one-quarter segment.

The majority read the record as conclusively establishing "that knowledge of the results of the discovery hole, K-55-1, would have been important to a reasonable investor and might have affected the price of the stock." But disclosure of the "results", namely, preliminary visual inspection of the contents, would have violated the Commission's own rules and standards. The Commission has specifically declared (Sch. I, Form 1-A, Reg. A offerings under the 1933 Act):

> "No claim shall be made as to the existence of a body of ore unless it has been sufficiently tested to be prop-

erly classified as 'proven' or 'probable' ore, as defined below. If the work done has not established the existence of proven or probable ore, a statement shall be made that no body of commercial ore is known to exist on the property."

Item 8(A)(b), 1 CCH Fed. Sec. L. Rep. ¶7327.

The Commission has carefully defined the scope of sampling required to justify even estimates, as follows:

> "The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore."

Id., Item 8A(c), 1 CCH Fed. Sec. L. Rep. ¶7327.

Thus under the Commission's own standards, TGS, if it revealed any information during the November 1963-April 1964 period, would have had to announce to the public in substance "TGS has drilled a 1⅛" core on a one-quarter section owned by it in Timmins, Canada. Although the core appears to have excellent mineral content 'no body of commercial ore is known to exist on the property.'" Contrast such a statement with the April 12, 1964 release so criticized by the Commission. Further contrast it with a hypothetical November 1963 press release implicitly suggested by the majority "TGS as a result of drilling on its property in Canada has knowledge of the more than marginal possibility of a mine of magnitude over an extensive region of remarkably rich mineralization."—a statement which under the circumstances and then known facts would have been the height of recklessness.

In fact, the Commission itself indulges in the very speculation it condemns for, after conceding that "the trial court correctly stated that one drill hole does not establish the existence of a commercially mineable mineral deposit," it straightway contends that the information which arose after the drilling of this first and only (for 4½ months) drill hole revealed such "chances of imminent success, viewed in the light of the magnitude of the potential economic benefit to Texas Gulf" as to require disclosure by insiders desiring to buy TGS securities.

The Commission's position, consistent with its rules and regulations to protect the public from premature announcements which might well arouse speculative fervor are well expressed in its argument before this Court in its brief on appeal in *Securities and Exchange Commission* v. *Great American Industries, Inc., et al.,* 259 F. Supp. 99, S. D. N. Y., 1966, where it said:

> "Neither the Commission, the sellers, nor anyone else knew or could establish the value of the [mining] properties since they had not been explored except in a very preliminary way. No one can prove the value of a largely unexplored mining prospect" (p. 19).

The conservative (and in my opinion proper) approach of the Commission in *Great American* is reflected in its statement that "The ore content of a property is never 'known' until the ore has been completely removed and the minerals separated." This is probably an overstatement because by the time of the TGS April 16, 1964 press release, exploration had advanced to a point where an estimate of the extent of the tonnage might have been rather accurately made. The Commission in that case also stated two truisms (1) that "it is extremely important that all facts relevant

to an estimate of the value of such property be disclosed," and (2) that "the judgment of the 'value' of this property is dependent upon the results of exploratory work * * *" (*Great American* brief, pp. 22, 23).

On November 12, 1963 drilling of K-55-1 was terminated at 655 feet. The core of the drill hole contained relatively high percentages of copper and zinc and some silver, although the percentages at any given point fluctuated widely. This result undoubtedly "excited the interest" of the TGS exploration team. TGS decided to acquire the surrounding plots in the Kidd 55 area to enable it fully to investigate the anomaly. The attempt to acquire the adjoining properties at reasonable prices (ultimately $52,500) and the strictures on secrecy are customary in the mining industry, especially when dealing with land of a highly uncertain value. After all, TGS had prior experience in exploration where initially promising situations turned out to be "duds." For example, the company had spent some $7,000,000 to purchase an underwater dome off the coast of Texas and an additional $1,000,000 to drill 21 holes before concluding that there was not enough sulphur in the dome to be of commercial interest.

However, until drilling was resumed, nothing further was learned about the ore content of the property other than as revealed in November and December 1963 from the analysis of K-55-1. The trial court's finding as to this fact is unassailable:

> "The most that can be said of the individual defendants' knowledge after the drilling of K-55-1 is that they had 'hopes, perhaps with some reason,' that it would lead to a mine. *James Blackstone Mem. Lib. Ass'n* v. *Gulf, M. & O. R. Co.*, 264 F. 2d 445, 450 (7th Cir. 1959). The results of K-55-1 were too 'remote'

when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, i.e., to be deemed material." 258 F. Supp. at 283.

This conclusion is amply supported by the record. Kidd 55 was only one of several thousand anomalies (areas where there is unusual variation in the electrical conductivity of rocks) that TGS detected in its aerial exploration of the Canadian shield. Several hundred of these were considered worthy of further study and options on the land around them were acquired. The District Court found that "TGS had previously drilled 65 equally promising anomalies, but most of them had revealed either barren pyrite or graphite, while a few had shown marginal mineral deposits in insufficient quantities to be commercially mined" (258 F. Supp. at 271).

Against this factual background, what position should have been taken by those few officers and employees of TGS after they knew of the core, K-55-1, and the reports thereon made after visual inspection and analysis? There were several choices. Knowing that the nature and extent of this prospect could not be measured until further exploration was conducted and that further exploration had to await additional land acquisition they could have made no announcement as was the case here.

Turning now to the hypothesis of disclosure: As previously stated, any announcement of the discovery of a remarkable mine would have been both false and misleading. The Commission, however, impliedly suggests for affirmative answer the question: "Whether the chances of imminent success, viewed in the light of the magnitude of the potential economic benefit to Texas Gulf" did not require disclosure by insiders of the status of the drilling [then

only the first hole, K-55-1]? In the field of speculation, it would be interesting to know the position the Commission would have taken if TGS had announced that K-55-1 was "one of the most impressive drill holes completed in modern times" and that it "is just beyond your wildest imagination" (SEC Brief, p. 25). It requires no imagination to venture that such announcements might well have had the "wildest" impact on the market price of TGS stock.

Assuming the majority's and the Commission's full disclosure theory, would the facts as then developed have given the buying or selling public the so-called advantages possessed by the insiders? TGS could have announced by November 15, 1963 that it had completed a first exploratory hole, the core of which by visual examination revealed over a length of 599 of 655 feet drilled, an average copper content of 1.15%, zinc 8.64% or, had TGS waited until mid-December, by chemical analysis 1.18% copper, 8.26% zinc and 2.94% ounces of silver per ton; that TGS would try to acquire the other three-quarters of the segment unless the announcement boosted prices to unwarranted heights; that if the property could be acquired further exploratory holes would be drilled to ascertain the nature and extent, if any, of the ore body; that reports of developments would be made from time to time but that the SEC had indicated that TGS should advise its stockholders and the public that there was no proof as yet that a body of commercial ore exists on the property. Such an announcement would, of course, have been of no value to anyone except possibly a few graduates of Institutes of Technology and they, as the expert witnesses here, would have recognized that one drill hole does not reveal a commercially profitable mine.

The final question to be answered is: were these officers and employees disqualified as the result of possessing information gleaned by the first drill core from purchasing

TGS stock? The number of possibilities for Congressional legislation and Commission rulings are legion. They extend over a gamut between definite extremes. At one extreme is a rule that no officer or employee or any member of their families shall own stock of the company for which they work or purchase stock if he possesses "material" inside information. This assumption raises the question of what is material and who is to make such a determination. Materiality must depend upon the facts and their resolution is for the fact-finder, court or jury. The majority state that the K-55-1 drilling results were material because they "might well have affected the price of TGS stock." But such a statement could be made of almost any fact related to TGS. If a labor strike had kept its plants idle for months, encouraging news of a possible settlement hoped for by the TGS labor negotiators might cause the negotiators to buy. Their belief that the strike would be protracted might cause them to sell. Either announcement might well have affected the market and would to those who bought or sold have seemed misleading and deceptive if the anticipated event did not come to pass. Yet the requirement of hourly bulletins to the press from the conference room would not be compatible with common sense. Scores of day by day intra-company situations come to mind which in the individual opinions of company officers or employees might well affect the price of TGS stock, each individual reacting according to his own judgment. However, companies listed on a national exchange can scarcely broadcast to the nation on a daily basis their hopes and/or expectations from the developments in, for example, their research departments. An even more striking illustration would be found within the structure of a large pharmaceutical company where discoveries of panaceas to cure human disease occupies the workdays of thousands of scien-

tists. Premature announcements of important discoveries would be branded as false and misleading if unfulfilled and all stock purchases made during the course of the research, if ultimately successful would be said to have been made with the advantage of inside information. At the other extreme is an equally easy-to-resolve *Cady, Roberts*[1] situation where a definite fact (the reduction of the dividend) was known by an insider, who participated in the meeting where the decision had already been made, whose knowledge of the probable reaction of the market to such an announcement, namely, a substantial sell-off, caused him to leave the meeting ahead of everyone else and before the potential buyers learned of the bad news to foist his selling orders on the market and his stock on uninformed purchasers. Between these extremes there should be a rule of reason.

Faced with this problem, the trial court selected a period from November 12, 1963 (the first information) to some date after drilling was resumed when it might reasonably be said that a body of commercially mineable ore *might* exist. The trial court, accepting the Commission's experts' version, fixed 7:00 p.m. on April 9, 1964 as the time when TGS had material information which "if disclosed, would have had a substantial impact on the market price of TGS stock" but also found that "the drilling results up to 7:00 p.m. on April 9th did not provide such material information." These findings are clearly supported by the proof upon which the court relied.

Practically all TGS stock in question here was purchased between November 12, 1963 and April 8, 1964. What were the motives behind each of the purchases? Obviously, a subjective approach presents difficulties. A myriad of reasons would be given—hope that a commercially profitable

1 *In re Cady, Roberts & Co.*, 40 SEC 907 (1961).

mine would be found if further exploration proved the ore to be as promising as the core of K-55-1 (November 12, 1963); the development of a phosphate project and potash mine (November 15, 1963); the prediction of security analysts that there would be a turnabout in the price of sulphur stocks; the acquisition of Canadian oil properties (December 16, 1963); the new high level of free world sulphur use and output (December 30, 1963); the launching of the world's largest liquid sulphur tanker (December 30, 1963); the entry into service of a large liquid sulphur tanker for domestic shipments (January 18, 1964); the sulphur expansion program in Canada (February 8, 1964); the new four-year high in sales reached in 1963 (February 20, 1964); and the $2 per ton price increase for sulphur (April 1, 1964).

There can be little doubt but that those familiar with the results of K-55-1 were influenced thereby in making their purchases. The conclusion of the majority is based primarily on this assumption. They call it "a major factor in determining whether the K-55-1 discovery was a material fact" and say that this "virtually compels the inference that the insiders were influenced by the drilling results." To them, completely disregarding the trial court's findings and substituting themselves as a jury, these purchases are "the only truly objective evidence of the materiality of the K-55-1 discovery." In so holding, they confuse the inducing motive of the individual purchaser with knowledge of material facts which ought to be revealed to the public at large. The inconsistency of the majority's position is immediately apparent. Those who purchased were apparently willing on the basis of the inconclusive first hole and other information to risk a certain amount of their funds in TGS stock, hopeful that

future developments would be favorable. Their motive for purchase does not establish the materiality of the facts which influenced them. However, the importance of this case to the corporate and financial community centers around the news release, its timing and its content. It is unfortunate that the atmosphere surrounding this important issue has been so colored and in the collective mind of the majority so contaminated by the comparatively insignificant stock purchase issue.

The resolution, if such be possible, of the many problems presented in this field should be by rule, as definite as possible, formulated in the light of reality and not retroactive in effect as here. I understand that the Commission has conducted, or is conducting, hearings to enable it to learn the views of the many persons and corporations affected. Presumably the Commission will make recommendations to the Congress to give that body an opportunity to accept or reject after thoughtful debate such proposals as may be made. The companies, the securities of which are listed on exchanges, their employees and investing public alike should have some knowledge of the rules which will govern their actions. They should not be forced, despite an exercise of the best judgment, to act at their peril or refrain *in terrorem* from acting. As to a waiting period after the information regarded as "material" has been disclosed, any such time period should be specifically fixed by Congressional or Commission rule not retroactive in application. There is no proof here that the purchases of the defendants, even if motivated by hopes not then solidly grounded, raised or lowered the market or were manipulative, misleading, deceptive or were accomplished by false or fraudulent devices. The trial court after hearing and seeing the witnesses has resolved these factual issues and in my opinion its decision should be sustained.

Stock Options

On February 20, 1964 the stock option committee, which was not informed of the developments at Kidd 55, granted options to Stephens, Fogarty, Mollison, Holyk, Kline and a number of other top officers of TGS. Since only K-55-1 had been drilled at that point, the District Court correctly held that there was no duty of disclosure on the part of those receiving the options. Assuming *arguendo* that the information was material, those not in top management have no duty to disclose to the directors information already reported to their own superiors since they may reasonably assume that the information has been conveyed to the directors on the stock option committee. The District Court held that Holyk, Mollison and Kline were not in top management and that Kline was ignorant of the details of the drilling results, so as to them no violation of 10b-5 had been made out. The majority disagree as to Kline, placing him in top management along with Stephens and Fogarty, and holding that he had sufficient knowledge that his nondisclosure violated Rule 10b-5. Since the majority admit that Kline "knew only that a hole containing favorable bodies of copper and zinc ore had been drilled in Timmins," it seems clear that he did not possess material information that had to be disclosed. That being the case, I find it unnecessary to decide whether or not Kline was in "top management."

As to Stephens and Fogarty, the majority decision places insider recipients of stock options in a difficult dilemma. Under the majority's decision, an insider must perform the uncommon act of refusing such an option, promoting speculation as to the reasons therefor, or accept the option and face possible 10b-5 liability. The objective of protecting a corporation from selling securities to insiders at a

price below their true worth is fully served by requiring nondisclosing insiders to abstain, not from accepting the stock options, but merely from exercising them—an event likely to occur after the inside information has become public. In any case, the failure to exercise an option is less likely to suggest that the insider possessed material information than the failure to accept such an option. Since the option granted to Kline had not been exercised prior to its ratification by the Texas Gulf directors on July 15, 1965, after full disclosure, there can be no 10b-5 violation as to him, and rescission of the option he received should not be ordered. As Stephens and Fogarty have surrendered the options and the corporation has canceled them, there has certainly been no violation of 10b-5 by them with respect to those options.

The April 12, 1964 Press Release

The majority suggest with, in my opinion, most remarkable business naivete that, instead of the April 12, 1964 press release which the trial court had found as a matter of fact had been issued in the exercise of "reasonable business judgment under the circumstances," in their 1968 judgment "it would have obviously been better to have specifically described the known drilling progress as of April 10th by stating the basic facts." They also suggest that "[s]uch an explicit disclosure would have permitted the investing public to evaluate the 'prospect' of a mine at Timmins without having to read between the lines to understand that preliminary indications were favorable—in itself an understatement." Had TGS followed this *ex post facto* directive, it first would have had to find some news medium capable of reaching the nation's potential investing public and willing to publish a mass of metallurgical reports disclosing

the "basic facts." Any such procedure would have invited the initial question on cross-examination of TGS officials: How could any such "explicit disclosure" have permitted the investing public to evaluate the prospect of a mine, without the necessity of transmitting it for expert opinion to some School of Mines? Of course there would be but one answer: It could not.

The facts as established between the date of the resumption of drilling and the drafting of the release are as follows:

On March 31, 1964 TGS moved four drill rigs onto the property, and by April 10th all were in operation. On Friday morning, April 10th, Mollison and Holyk visited the property and learned the results of the drilling up to that time. Mollison left for New York that evening, arriving on Saturday morning. Holyk left for New York Saturday morning and arrived that same day. Until Saturday morning TGS did not intend to issue a press release on the progress of the exploration.

Despite rumors in the Canadian press that TGS had made a major discovery, Lamont had advised Stephens "that TGS should take no action unless the rumors reached the New York press or until TGS had sufficient information available to issue an appropriate press release." 258 F. Supp. at 293. On Saturday morning, April 11th, both the New York Herald Tribune and the New York Times prominently reported a major ore discovery. In a front page article carrying the title "Canada's Copper Rush" the Herald Tribune stated "The biggest ore strike since gold was discovered more than 60 years ago in Canada has stampeded speculators to the snowbound old mining city of Timmins . . . ." The article also stated that the richness of the copper was so great that the core was flown out of the

country to be assayed and that four more drill rigs were scheduled to start working the following week. All of these statements were inaccurate and a matter of concern to Fogarty and Stephens.[2] Stephens advised Fogarty that TGS should issue a press release to clarify the rumors that Fogarty therefore contacted Mollison who had just returned from Timmins.

Mollison had been advised by Holyk as to the drilling results up to 7:00 p.m. on April 10th. On the basis of this information he, as an experienced mining engineer, did not feel that there was sufficient information to draw conclusions as to size and grade of ore, and he advised Fogarty accordingly.

The District Court held:

> "In seeking the advice of Mollison, the head of TGS's exploration group, in consulting with TGS's public relations firm, and in clearing the release with one of TGS's lawyers, Stephens and Fogarty exercised reasonable business judgment under the circumstances." 258 F. Supp. at 296.

The press release was drawn up with the aid of the above-mentioned persons on Saturday and Sunday morning, and was delivered to the press on Sunday for publication in the Monday papers. It stated in part:

> "Recent drilling on one ore property near Timmins has led to preliminary indications that more drilling

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2 The New York Stock Exchange Company Manual provides:

"Dealing with Rumors Affecting the Market: Occasions may also arise when rumors have been circulated which have no basis in fact or which require clarification or interpretation and which also result in unusual activity or price changes in a particular security. Under such circumstances, the most effective procedure is the quick and speedy denial of such rumors through a release to the public Press . . ."

would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

"The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

The majority offer suggestions for improving the press release, but, as their editorial skills and present appraisal of the then mining situation were not available when it was drafted, the relevant issue is whether the District Court was in error in determining that the release was accurate and not misleading.

By 7:00 p.m., April 10, the following data was available:

1. geologists' logs of visual estimate and chemical assay of the results of K-55-1,
2. preliminary estimates of 757 feet of K-55-3 and unrecorded visual estimates of 569 feet of K-55-6, both drilled on the same line as K-55-1 (2400 S),
3. unrecorded visual appraisals of 476 feet of K-55-4, drilled 200 feet to the south of K-55-1, and
4. unrecorded visual appraisals of only 97 feet of K-55-5, drilled 200 feet to the north of K-55-1.

The Commission's experts testified that because copper and zinc had been found in these five holes (although in vary-

ing percentages) it could reasonably be concluded that the mineralization was continuous between holes 400 feet apart and also 100 feet beyond in each direction and to a depth of 600 feet, one hundred feet below the deepest hole. However, the District Court found that:

> "TGS's experts were unanimously of the opinion that at 7:00 p.m. on April 10 the Kidd 55 segment was still a prospect and that no estimates as to proven or probable ore could be made. They all agreed that the April 12 press release accurately set forth the situation as it was known at the time. None thought that TGS could have estimated proven ore, and the Commission's expert, Pennebaker, agreed that this was a matter on which there could be differences of opinion. Defendants' experts testified that on the basis of the drilling to that time there was no assurance of continuity in the mineralized zone and that, without further drilling, the results of one hole could not be correlated with the results of others." 258 F. Supp. at 295.

The April 12 release therefore correctly described Kidd 55 as a "prospect." While that term is a word of art in the mining trade used to describe "a property where there is no assurance, from the information known, that a commercially mineable ore body exists" [Pennebaker], its technical definition is no different from the definition in common use. See Webster's New International Dictionary (2d ed. unabridged 1960). Nor is there any inconsistency between the release and the District Court finding that as of April 9, 1964 "there was real evidence that a body of commercially mineable ore *might* exist." 258 F. Supp. at 282 (emphasis added). The District Court characterized the press release as an accurate portrayal of the situation as it was known

at that time. The inference is therefore inescapable that the Court felt that a reasonable investor would not be misled by it. The Commission's whole argument appears to be that the release should have been more optimistic (if conclusions were to be used at all), and that it should have referred to Kidd 55 as having "proven" or "probable" ore. But such a press release would have been highly misleading since the information necessary to draw such conclusions was not available on April 10—according to the TGS witnesses whom the District Court chose to believe.

As evidence that the April 12 release was probably inaccurate, the majority point to the fact that only three days later TGS prepared the April 16 release which announced a major mineral discovery. However, this release was based on more information of significance than was available on April 10 at 7:00 p.m. Between April 12 and April 15 five additional holes had been drilled, K-55-5, 6, 7, 8 and 10 and by April 15 at 7:00 p.m. 5198 feet of core had been drilled compared with 2776 feet on April 10. Furthermore, the location of drilling holes is critical in determining continuity. Most of the footage drilled by April 10 had been in a single plane (2400 S), but by April 15 drilling had established mineralization in a number of additional planes. There is therefore no inconsistency in the statements made and the conclusions reached in the two releases.

The majority remand for a determination of the effect of the April 12 release on a reasonable investor because in its opinion "the effect of this release on the investing public was equivocal and less than abundant." The evidence of the actual effect of the release on investors was at best inconclusive. The Commission offered no proof that anyone was misled by the release—e.g. testimony tending to show that most investors thought the release meant that TGS had no hopes of making an ore discovery. Those

that had been advised by the broker Roche to purchase stock did not sell upon reading the April 12 release. Several brokers testified that they interpreted the release as affirmative and encouraging. The market opened at 30⅛ on the 13th (when the release became public) and closed at 30⅞—scarcely a sign of public pessimism. The next day the market closed at 30¼. The District Court correctly found that "the issuance of the release produced no unusual market action." 258 F. Supp. at 294. Nor did he find the release to be "gloomy." His statement was that: "While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known." 258 F. Supp. at 296. With the aid of hindsight the release may indeed seem gloomy, but that is because it is now known that a very substantial tonnage of ore exists. Hindsight, however, is not the test. Furthermore, even if some investors considered the release to be discouraging compared to the rumors afloat, if the facts and conclusions presented were accurate (as they were) and if they were not presented in a manner that would mislead a reasonable investor (which they were not) then there can be no violation of 10b-5.

The District Court aptly pointed out that in quelling the rumors TGS had to proceed with caution:

> "If they said too much, they would have been open to criticism and possible liability if it turned out that TGS had not discovered a commercial mine. If they said too little and later announced a mine, they subjected themselves to the charge that their press release was misleading or deceptive—and, indeed, this is what has happened." 258 F. Supp. at 296.

While it thus might have been "safer" for TGS to have issued a sheaf of drilling results and mineral analyses

(which the press would probably have declined to print), "they would have [thereby] encouraged the rumor mill which they were seeking to allay." *(Ibid.)* Stephens and Fogarty decided that the best course was to give their evaluation of the situation—a reasonable business judgment that should not incur 10b-5 liability unless their evaluation was either false or misleading. The experts which the trial court credited were of the opinion that Kidd 55 was accurately portrayed as a prospect which required further exploration. The trial court found that the release was not "misleading or deceptive on the basis of the facts then known," and the majority state that from the record they cannot "definitively conclude that it was deceptive or misleading to the reasonable investor." It would therefore appear that the Commission has failed in its burden of proof, unless it can be said that TGS was negligent in not obtaining later data from Timmins before issuing the release.[3]

Of necessity the April 12 press release had to be issued on the basis of the drilling results through 7:00 p.m., April 10, and it seems clear that the trial court determined that it would not be reasonable to charge TGS with knowledge of later information. While additional drilling was done on Saturday and Sunday, April 11 and 12, the cores had not been seen by the geologists advising management, and there was no way of communicating with the drill site even if someone had been available there to give a reliable appraisal. Mollison and Holyk were in New York for the weekend, and there was no telephone at the site—the only way to communicate with the site was to go there. The decision to issue a press release was not made until Satur-

3 Of course, even if TGS were negligent in not obtaining later data, a determination must still be made that the press release was misleading in light of this later information.

day, at which point Fogarty testified it "would just be very difficult for us to try to find anyone in Timmins." The statement was released Sunday afternoon and Mollison and Holyk were asked "to return to Timmins as promptly as possible and to move things along." It therefore cannot be said that TGS was negligent in not obtaining more current data, and it is certainly not negligent simply because it decided to issue the statement when it did. A remand on this point is therefore not justified.

The "in connection with" Clause Precludes the Imposition of §10(b) Liability on TGS.

In any event, the Commission still has the problem of showing that the other requirement of the statute and rule is met, namely that the release was issued "in connection with" a securities transaction on the part of TGS. This requirement is explicit in §10(b) of the Act (15 U. S. C. §78j) which provides:

> It shall be unlawful for any person . . .
>
> (b) To use, or employ, *in connection with the purchase or sale of any security* registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to this authority the Commission in 1942 promulgated Rule 10b-5 (17 C. F. R. §240.10b-5) which states:

> Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person . . .
>
> (a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security.*

In determining whether the requisite "connection" to a securities transaction was present in this case, the District Court found:

"From the foregoing, it is apparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment. There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage. The issuance of the release produced no unusual market action. In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or Rule 10b-5 since it was not issued 'in connection with the purchase or sale of any security.'" 258 F. Supp. at 294.

The District Court held that if TGS or its insiders had purchased TGS stock after issuing the allegedly misleading press release, the inference could be drawn that it was issued to reduce the price of the stock to facilitate purchases at bargain prices. Such a deceptive or manipulative

practice would be prohibited by 10(b) and Rule 10b-5. See *Gann* v. *BernzOmatic,* 262 F. Supp. 301 (SDNY 1966); *Cochran* v. *Channing Corp.,* 211 F. Supp. 239 (SDNY 1962). Moreover, noting that the "in connection" clause has been broadly construed, the District Court did not require that stock purchases by TGS or insiders be shown. Instead, the court held that "the issuance of a false and misleading press release may constitute a violation of Section 10(b) and Rule 10b-5 if its purpose is to affect the market price of the company's stock to the advantage of the company or its insiders. *Freed* v. *Szabo Food Serv., Inc.,* CCH Fed. Sec. L. Rep. ¶91,317 (N. D. Ill. 1964)." 258 F. Supp. at 293. Thus, even if TGS or its insiders had not engaged in securities transactions, if there were evidence from which it could be inferred that the press release was intentionally issued to depress the price of the stock as part of some fraudulent scheme, a 10b-5 violation would have been stated.[4] But in this case the only purpose of the press release was to quell the extravagant rumors circulating about the Canadian exploration project. No facts whatsoever were adduced which would have justified a finding that the release was issued for a fraudulent or manipulative purpose. To hold that such a statement incurs 10b-5 liability is contrary to the intent of Congress in passing §10(b) and settled judicial construction. Furthermore, such a holding might well have the unfortunate result of deterring the dissemination of corporate news despite the strong policy underlying all securities legislation of encouraging disclosure of information useful to present and potential investors. If press releases have to read like prospectuses to guard against possible 10b-5 liability, it is safe to predict that they will quickly fall out of favor with corporate management.

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4 Whether the release had any such effect would, of course, be irrelevant.

The Commission advances the argument (successful with the majority) that the "in connection" requirement is satisfied by the mere fact that the public is purchasing and selling securities on the open market. Thus any statement issued by a publicly listed company is made "in connection" with the purchase or sale of securities. The majority approve of this interpretation because "the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose." However, the fact remains that §10(b) of the Securities Exchange Act was not passed to protect investors from the former type of injury, but leaves liability for such misrepresentation up to state law, which is well equipped to handle any such situation. See, e.g., Note, Accountant's Liabilities for False and Misleading Statements, 67 Colum. L. Rev. 1437 (1967). Section 10(b) was certainly not intended to be a mandate to the Commission to erect a comprehensive regulatory system policing all corporate publicity, as the majority now contend. The legislative history clearly reveals that the statute was passed to prohibit deceptive and manipulative devices used in connection with securities transactions, and that the "connection" between the complained of conduct and the securities transactions must be a closer one than the majority now sanctions. See S. Rep. No. 792, 73rd Cong., 2d Sess. (1934); H. R. Rep. No. 1383, 73rd Cong., 2d Sess. (1934); S. Rep. No. 1455, 73rd Cong., 2d Sess. (1934); Comment, 74 Yale L. J. 658, 681-82 (1965).

The broad congressional purpose in passing the Securities Exchange Act of 1934 is set forth by Thomas G. Corcoran, one of the draftsmen of the bill that became the 1934 Act. He stated at a 1934 House hearing that "this bill has

at bottom five ideas in it, and all 36 pages tie in around the five ideas." According to Corcoran these five ideas were (1) control on the amount of credit, (2) control of manipulations, (3) control of insider trading [§16(b)], (4) elimination of abuses in the market machinery, and (5) the establishment of the Securities Exchange Commission to administer the Act. As to manipulation, he testified that:

> "As I will point out later, there are only a very few real battlegrounds in this act. Manipulation is not one of them. The provisions of this bill, as to manipulations upon stock exchanges, are agreed to practically everywhere, . . . Matched orders, washed sales, pools, options —all of the rest of them are out. So, control of manipulative practices is really not something your committee has to thrash out around this table." [5]

It is therefore not surprising that there is little discussion in the legislative history as to the meaning of the language in the anti-manipulation provisions. It was obviously thought that sections outlawing devices that had been shown at great length to be deleterious did not require any lengthy explication. This is unfortunate because it has resulted in §10(b) being given a construction and significance which, in my opinion, Congress did not foresee and did not intend.

This conclusion is fortified by the provisions of the Act dealing with manipulation since the more specific prohibitions make it clear what evils Congress intended to eradicate by §10(b). Section 9, 15 U. S. C. §78i provides that it shall be unlawful for any broker, dealer or other person to create a false or misleading appearance of activity in the

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5 Hearings before the House Committee on Interstate and Foreign Commerce on H. R. 7852 and H. R. 8720, 73rd Cong., 2d Sess. (1934).

market for a stock or to attempt to affect the price of a stock by certain specific manipulative devices.

Section 10(a), 15 U. S. C. §78j provides:

> Manipulative and Deceptive Devices
>
> It shall be unlawful for any person . . .
>
> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Read in context it seems clear that §10(b) was only meant to be a supplement to the specific prohibitions contained in §9 and §10(a). Commenting on the section that became §10(b), Corcoran stated:

> "Subsection [b] says, 'Thou shalt not devise any other cunning devices.' . . . Of course subsection [b] is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices."

Since the manipulative devices outlawed by §9 all involve fraudulent activities integrally related to securities transactions, the conclusion necessarily follows that the "other cunning devices" sought to be prohibited by §10(b) and Rule 10b-5 are those which also involve securities transactions as an integral part of the fraud. The statute as enacted requires that the fraudulent scheme be "in connection with the purchase or sale of any security." The

expression "in connection" is used elsewhere in the Act, including §9(b), as a shorthand method of indicating that the activity sought to be made illegal is that having a direct relation to securities transactions. The majority read the phrase as merely requiring that the allegedly misleading statement be issued by a publicly traded corporation. They argue that the "connection" that has to exist between a corporate statement and a security transaction is supplied by the theoretical argument that every "material" corporate statement presumably affects the market price of the issuer's securities. In my opinion such a broad interpretation of the statute is unwarranted as a matter of statutory construction and unwise as a matter of policy.

Congress has made it clear in the other antifraud provisions of general application that its concern was not with allegedly misleading corporate publicity but rather with purposeful schemes to deceive and defraud the public by means of manipulative and deceptive devices which directly involve purchases or sales of securities. Thus §12(a), 15 U. S. C. §77*l* of the 1933 Act provides that any person who "offers or sells a security" by means of a prospectus or oral communication which includes a misstatement or omission of a material fact shall be civilly liable. Similarly §17(a) of the 1933 Act, 15 U. S. C. §77q(a), provides that it "shall be unlawful for any person in the offer or sale of any securities" to engage in fraudulent activity.

A further insight into the proper scope of 10b-5 can be gained by examining §17(a), 15 U. S. C. §77g(a) which is almost word for word the same except for the explicit requirement that any alleged fraud be associated with "the offer or sale of . . . securities." The only difference of substance between §17(a) and Rule 10b-5 is that the latter applies to purchasers as well as sellers. *Ellis* v. *Carter*,

291 F. 2d 270, 272-274 (9th Cir. 1961); SEC Sec. Exch. Act Rel. No. 3230 (May 21, 1942) ("The new rule closes a loophole in the protection against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."); Milton Cohen, "Truth in Securities Revisited," 79 Harv. L. Rev. 1340, 1364 (1966).

Finally, §15(c)(1), (2), 15 U. S. C. §78o(c)(1), (2) provides that no broker or dealer shall (1) induce the purchase or sale of any security by means of any manipulative, deceptive or other fraudulent contrivance or (2) attempt to induce the purchase or sale of any security "in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice . . . ."

The majority argue that when compared with the above provisions the slight change of wording in §10(b)—the insertion of the phrase "in connection with . . . "—indicates that Congress intended a revolutionary change in the whole thrust of the securities laws. That is too slim a basis to support a judicial excursion over such uncharted seas. It is most doubtful that Congress intended such a result, and the merits of such a change are so unexplored that Congress should certainly be consulted before making it.

The majority support their action in part by a long quotation from H. R. Rep. No. 1383. It should be noted that the discussion at that point of the report is not addressed to §10(b) but to the reporting and disclosure provisions of Securities Exchange Act of 1934, specifically §§12-14, 16. Section 12 of the Act, 15 U. S. C. §78*l*, requires the registration of securities traded on a stock exchange and of certain other widely held securities. Detailed information similar to that required by the 1933 Act has to be filed with the Commission for such registered securities, and this infor-

mation is required by §13, 15 U. S. C. §78m, to be kept "reasonably current" by periodic and other reports filed with the Commission and the stock exchanges. In addition §16(a), 15 U. S. C. §78p(a), requires certain officers, directors and major shareholders to file reports with the Commission and the stock exchanges as to their initial holdings of stock and subsequent changes. Finally, pursuant to §14, 15 U. S. C. §78n, the Commission has promulgated proxy rules setting forth information that must be sent to shareholders prior to their annual or other meetings. See Schedules 14A-14C, 17 C. F. R. §240.14a-101–103.

To encourage compliance with these disclosure and reporting requirements, Congress enacted civil (§18, 15 U. S. C. §78r) and criminal (§32, 15 U. S. C. §78ff) provisions. A close reading of §18 will demonstrate that a plaintiff proceeding under that section (as opposed to §10(b)) does not have to show that the misleading statement was issued by a person [or corporation] who engaged or participated in a securities transaction or even that the misstatement was intended to influence securities transactions as part of some fraudulent scheme. Therefore, the statements in the legislative history applicable to the reporting and disclosure provisions have no bearing on the correct interpretation of §10(b). That section was not meant to be an auxiliary disclosure device or a provision to punish those who issue inaccurate statements in newspapers or documents filed with the Commission *unless* they are fraudulent acts integrally connected with securities transactions. If there is no such connection, investors are relegated to §18 or state law to recover their losses and the Commission must use its other remedies, discussed *infra*.

In discussing Rule 10b-5 Cohen expressed concern which, as a result of the majority opinion, seems to have been well

founded, that Rule 10b-5 would be given an "unwarranted" extension. In "Truth in Securities Revisited," *op. cit. supra,* at 1366, he said:

> "Nor is it clear that Rule 10b-5 will not be read as providing an alternative remedy (alternative to the considerably more limited express remedy of section 18) for false or misleading statements in filing under sections 12 and 13. One might regard these as surprising and even unwarranted extensions of Congress's terse proscription of 'any manipulative or deceptive device or contrivance' in section 10(b) and yet not care to predict confidently that the momentum of decisions will not carry this far."
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> * * * * *
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> " . . . I firmly believe that whatever inadequacy is found in §18, as the basic civil liability provision applicable to the continuous disclosure system, ought to be taken care of by direct amendment of the section itself, not by resorting to the broader, vaguer, but (in my view) otherwise directed provisions of Rule 10b-5. I believe that the problem of misrepresentation in a registrant's (issuer's) required filings is quite distinct from the problem of fraud or misrepresentation by a purchaser or seller of a security (even though the two areas sometimes overlap), and that more mischief than good is likely to come from confusing them or treating them as interchangeable."
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> (Cohen, *op. cit. supra* at 1370, n. 89)

The majority opinion must also be considered in light of its overall impact before a decision can be reached as to its advisability (assuming that the power to interpret §10(b) is as unlimited as the majority apparently believe).

It should be realized that the construction given 10b-5 will turn it into a comprehensive regulatory provision applicable to all corporate and individual statements, but without any of the detailed standards necessary to implement such a program. The Commission is presently arguing that 10b-5 is applicable to all corporate statements disseminated to the public or filed with the Commission. See *S. E. C.* v. *Great American Industries, Inc.*, 259 F. Supp. 99 (S. D. N. Y. 1966), appeal pending; *Heit* v. *Weitzen*, 260 F. Supp. 598 (S. D. N. Y. 1966), *Howard* v. *Levine*, 262 F. Supp. 643 (S. D. N. Y. 1965), consolidated appeal pending sub nom. *Heit* v. *Weitzen* (*amicus curiae*). The majority opinion appears to approve of the Commission's position without reservation.

The Commission's arsenal of weapons for fighting misleading statements has certainly not been shown to be insufficient for it to carry out the tasks that Congress assigned to it. Rule 10b-5 remains a potent method of proceeding against fraudulent schemes which involve securities transactions for both the Commission and private investors. The Commission can also obtain injunctions to enforce compliance with the disclosure and other provisions of the Securities Exchange Act (§21, 15 U. S. C. §78u), and stiff criminal penalties are provided for failure to comply with the statute or rules promulgated thereunder (§32, U. S. C. §78ff). The Commission can suspend trading for successive periods of 10 days in any security which it feels is being affected by misleading press releases (§§15(c)(5), 19(a)(4), 15 U. S. C. §§78o(c)(5), 78s(a)(4)). For an example of the effective use of this latter power see SEC Sec. Exch. Act Rel. No. 7741 (Nov. 4, 1965) relating to suspension in trading of Belock Instrument Corporation, a defendant in *Heit* v. *Weitzen, supra.* Finally, when faced

with the repeated issuance of misleading press releases, the courts can without more proof draw the inference that they were purposefully distributed to affect the price of the issuer's securities, justifying injunctive relief under 10b-5 and possibly other remedies. See *SEC* v. *Electrogen Industries, Inc.*, 68 Civ. 23 (EDNY, Feb. 26, 1968). In any event if the Commission feels that its arsenal should be augmented, Congress not the courts is the proper forum for its arguments.

Other Judicial Interpretation

The construction given the "in connection" clause by the District Court has been followed in the many cases that have considered the point. See *SEC* v. *North American Research & Development Corp.*, 1968 CCH Fed. Sec. L. Rep. ¶92,149 (SDNY Feb. 8, 1968); *Puharich* v. *Borders Electronics Co., Inc.*, 1968 Fed. Sec. L. Rep. ¶92,141 (SDNY Jan. 22, 1968); *Howard* v. *Levine*, 262 F. Supp. 643 (SDNY 1965), appeal pending; *Gann* v. *BernzOmatic*, 262 F. Supp. 301 (SDNY 1966) (dictum); *Heit* v. *Weitzen*, 260 F. Supp. 598 (SDNY 1966), appeal pending.

It is of course true, as the Commission points out, that the "in connection" clause has been given a broad construction by the courts in line with the remedial nature of securities legislation (see *SEC* v. *Capital Gains Bureau*, 375 U. S. 180, 195 (1965); cf. *Tcherepnin* v. *Knight*, 389 U. S. 332, 336 (1967)), but no case supports the Commission's position that it is in effect meaningless. The cases to date have involved defendants who if not actually purchasing or selling securities at least participated in a direct manner in a securities fraud.[6] Thus one who conspires with or aids and abets another in the fraudulent purchase or sale

6 In two cases, on motions to dismiss, two courts have permitted 10b-5 actions to continue where defendants were not alleged to be intimately

of securities may have the needed connection. See *Pettit* v. *American Stock Exchange,* 217 F. Supp. 21 (SDNY 1963) (Defendant Exchange and its officers allegedly aided and abetted an illegal distribution of stock by its failure to take necessary disciplinary actions against abusive conduct and practices of its employees of which they knew or should have known. Held: sufficient allegation of fraud under 10b-5); *Brennan* v. *Midwestern United Life Ins. Co.,* 259 F. Supp. 673 (N. D. Indiana 1966) (Defendant corporation allegedly aided and abetted an alleged violation of 10b-5 by its brokerage firm because of its failure to report the improper activities of said firm to the proper authorities. Held: cause of action stated under 10b-5).

Similarly, corporate officers or directors may be liable for causing their corporation to engage in securities transactions. See *Ruckle* v. *Roto American Corp.,* 339 F. 2d 24 (2d Cir. 1964) (Corporation allegedly defrauded into issuing securities to its President through the failure or refusal of some of its directors fully to disclose to the remaining directors material facts concerning the transactions or the financial condition of the company); *Bredehoeft* v. *Cornell,* 260 F. Supp. 557 (D. Ore. 1966) (Plaintiff induced to sell his stock to the corporation for less than its true value because the defendants, stockholders and directors of the company fraudulently concealed material facts); *New Park Mining Co.* v. *Crammer,* 225 F. Supp. 261 (SDNY 1963) (Defendants caused plaintiff corporations, of which they were officers, to issue stock for property which was worth much less than the stock); cf. *H. L. Green Co.* v. *Childree,*

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connected with a purchase or sale of securities. *Miller* v. *Bargain City, U. S. A.,* 229 F. Supp. 33 (E. D. Pa. 1964); *Fischer* v. *Kletz,* 266 F. Supp. 180 (SDNY 1967). But in both cases the courts recognized that further factual and legal development was necessary for the proper resolution of the issue.

185 F. Supp. 95 (SDNY 1960) (Accountants allegedly induced corporation to go through with a merger (a securities transaction) by preparing false financial statements and making other misrepresentations).

A corporation may itself violate Rule 10b-5 if it engages in fraudulent activities in connection with a merger or other transaction involving securities. See *Freed* v. *Szabo Food Service, Inc.*, '61-'64 CCH Fed. Sec. L. Rep. ¶91,317 (N. D. Ill. 1964) (Corporation, as part of a campaign to boost the value of its stock to achieve stockholder approval of a merger, deliberately issued statements misrepresenting future combined earnings. The price went up and the shareholders were impressed with this indication of the opinion of the financial community as to the proposed merger. The plaintiffs were held to have stated a cause of action under 10b-5 because they allegedly bought stock in the combined company on the strength of those misrepresentations.); cf. *Vine* v. *Beneficial Finance Co.*, 374 F. 2d 627 (2d Cir. 1967) (Corporation fraudulently arranged a merger so that one class of shareholders would receive much less than the other class which was comprised of officers and directors. While the alleged fraudulent acts were committed before plaintiff sold his stock (he had not at the time of suit), he was about to be forced to sell his part of a single fraudulent scheme.).

Another series of decisions involve a broker, dealer or financial institution which fraudulently induced plaintiff's purchase or sale. See *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (SDNY 1965) (Plaintiffs retained stock in a company solely because a broker misrepresented or failed to disclose certain material facts.); *Glickman* v. *Schweickart & Co.*, 242 F. Supp. 670 (SDNY 1965) (Broker induced plaintiff to purchase some stock and to finance the purchase through a factor without disclosing material facts concern-

ing the risks of such a procedure.); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (SDNY 1964) (Trust company alleged to be a participant in a fraudulent scheme whereby loans were made to plaintiff by a factor who converted the stock when it was pledged as collateral for the loan.); *Meisel* v. *North Jersey Trust Co.*, 218 F. Supp. 274 (SDNY 1963) (same); *Lorenz* v. *Watson*, 258 F. Supp. 724 (E. D. Pa. 1966) (Brokerage house liable to plaintiff if it failed to supervise adequately one of its employees who allegedly was guilty of "churning" or excessive turnover in plaintiff's account.). See also §§9(a)(4), 15(c)(1), (2), 15 U. S. C. §§78i(a)(4); 78o(c)(1), (2). In all of the above cases the defendants, unlike the defendant here, were clearly participants in a securities transaction and were guilty of or responsible for deceptive activities of which the securities transaction was an integral part.

The Injunction Remedy

The remedy of a permanent injunction against the company, its offiicers and agents, the issuance of which the majority leaves to the discretion of the trial court, would not only be inappropriate but would be destructive of fundamental rights—"inappropriate" because based upon one "too-gloomy" press release on April 12, 1964, with no proof of continuing gloominess thereafter. The issuance of any injunction over four years after the alleged violation would place a large company and its many executive employees under the possibility, without even a *Miranda* warning, that anything they say may be held against them and place them under the danger of criminal sanctions; "destructive of fundamental rights" because the restraint constitutes not "double" jeopardy but "perpetual" jeopardy. If, as the majority say, the test of the news release is its impact on the "reasonable" investor (although they indicate that the un-

reasonable speculator, too, comes under their solicitous wing) to avoid the danger of injunction violation it would be necessary to seek a declaratory judgment from the courts (both trial and appellate because following the majority, Rule 52(a) would no longer apply). As to the sufficiency of the news release, the first issue would be what constitutes a "reasonable" investor. After the court had made a preliminary finding of reasonableness, these investors could then testify as to the impact that the proposed release would have on them. Query, as to whether twelve witnesses (akin to a jury) should be required—and would a seven-to-five count be acceptable or would ten-to-two more accurately reflect public opinion? Other situations and problems of an equally *reductio ad absurdum* character can easily be conjured up. They would only point more directly to the conclusion that an injunction here would not only violate fundamental legal principles which for centuries have restricted the injunctive grant but would not be justified by any sufficient factual showing in this case. No clear and present danger, no continuing wrongful acts and no likelihood thereof are to be found in the record before this court.

Crawford, Clayton and Coates

Since I believe that the findings of the trial court are solidly founded and should be respected, I agree with its decision as to Crawford and Clayton. I agree with the majority as to Coates because for all practical purposes the information had not become public at the time of his purchase order.

Conclusion

In summary, the most disturbing aspect of the majority opinion is its utterly unrealistic approach to the problem

of the corporate press release. If corporations were literally to follow its implications, every press release would have to have the same SEC clearance as a prospectus. Even this procedure would not suffice if future events should prove the facts to have been over or understated—or too gloomy or optimistic—because the courts will always be ready and available to substitute their judgment for that of the business executives responsible therefor. But vulnerable as the news release may be, what of the many daily developments in the Research and Development departments of giant corporations. When and how are promising results to be disclosed. If they are not disclosed, the corporation is concealing information; if disclosed and hoped-for results do not materialize, there will always be those with the advantage of hindsight to brand them as false or misleading. Nor is it consonant with reality to suggest, as does the majority, that corporate executives may be motivated in accepting employment by the opportunity to make "secret corporate compensation . . . derived at the expense of the uninformed public." Such thoughts can only arise from unfounded speculative imagination. And finally there is the sardonic anomaly that the very members of society which Congress has charged the SEC with protecting, i.e., the stockholders, will be the real victims of its misdirected zeal. May the Future, the Congress or possibly the SEC itself be able to bring some semblance of order by means of workable rules and regulations in this field so that the corporations and their stockholders may not be subjected to countless lawsuits at the whim of every purchaser, seller or potential purchaser who may claim he would have acted or refrained from acting had a news release been more comprehensive, less comprehensive or had it been adequately published in the news media of the 50 States.

Appendix B

Opinion of the United States District Court

(5436) BONSAL, D. J.

Plaintiff, Securities and Exchange Commission (Commission), has instituted this action charging each of the defendants with violations of Section 10(b) of the Securities Exchange Act (15 U.S.C. 78j(b)) and Rule 10b-5 (17 C.F.R. 240; 10b-5) promulgated thereunder by the Commission. All parties waived a jury and agreed that trial should first be had on the issue of whether the defendants or any of them had violated Section 10(b) and Rule 10b-5, reserving for later hearing the issue of the remedy to be applied in the event such violations are found.

The Commission's action arises out of the exploratory activities of defendant Texas Gulf Sulphur Company (TGS) on the Kidd 55 segment near Timmins, Ontario, between November 12, 1963 and April 16, 1964. TGS is (5437) alleged to have violated Section 10(b) and Rule 10b-5 by issuing a false press release regarding these activities on April 12, 1964. Each of the individual defendants was a director, officer or employee of TGS. Individual defendants who purchased stock or calls on stock of TGS between November 12, 1963 and April 16, 1964, or recommended such purchases to others, are charged with violations of Section 10(b) and Rule 10b-5 on the ground that they used to their own advantage material information as to TGS's exploratory activities on the Kidd 55 segment, which material information had not been disclosed to or absorbed by the stockholders or the public. Five of the individual defendants who accepted stock options granted on February 20, 1964 are charged with violations of Section 10(b) and Rule 10b-5 on the ground that they

were in possession of such material information which they used to their own advantage by failing to disclose it to the Directors' Committee which granted the stock options.[1]

Texas Gulf Sulphur Company (TGS)

In 1963-64 TGS (which was organized in 1909) was the world's largest supplier of sulphur. Its authorized capital stock was 15,000,000 shares, without par value. (5438) 11,520,000 shares had been issued (including 1,504,101 shares held in the Company's treasury). On December 31, 1963, there were issued and outstanding in the hands of the public in excess of 10,000,000 shares held by some 65,000 shareholders. The stock of TGS was listed on the New York Stock Exchange and was admitted to unlisted trading privileges on the Midwest Stock Exchange. TGS's total assets, less current liabilities, had a book value of over $169,000,000 as of December 31, 1963, and over $210,000,000 as of December 31, 1964. The stockholders' equity was stated to be in excess of $129,000,000 as of December 31, 1963, and in excess of $137,000,000 as of December 31, 1964. Its annual sales were in excess of $62,000,000 for 1963 and in excess of $70,000,000 for 1964. Its working capital was approximately $47,000,000 as of December 31, 1963, and approximately $87,000,000 as of December 31, 1964. Its earnings per share for the period 1960-1964 were:

1960	1961	1962	1963	1964
$1.27	$1.26	$1.21	$0.93	$1.15

From 1955 to 1963 TGS's annual sales declined from $93,000,000 in 1955 to $62,000,000 in 1963 and its (5439) annual earnings from $32,000,000 in 1955 to $9,300,000 in 1963. This decline was attributed by TGS to the oversupply of sulphur, resulting in depressed prices during the period.

The market price of TGS stock on the New York Stock Exchange declined from a high of $45 a share in 1955 to a low of $11 a share in 1962. In 1963 the price rose from 13¾ in March to 19⅜ in November and to 21⅞ at the end of the year. In 1964 the price rose from a low of 21⅛ in January to a high of 30¼ on April 15. On April 16, the day of TGS's public announcement of the Kidd mine, the price rose from a low of 30⅛ to a high of 37, closing at 36⅜. The price continued to rise during the balance of April 1964 to a high of 58⅜ on April 30, on which day the stock closed at 54¾.

Between 1956 and 1963, despite a growth in the demand for sulphur, the price per ton of sulphur declined from around $28 in 1956 to under $20 in 1963. However, by late 1963 the turn-around had been reached. Sulphur became in short supply, and on April 1, 1964 TGS announced a $2 per ton increase in the price. TGS's gross sales for (5440) 1963 were the highest in four years, up 5.56% from 1962.

TGS's 1963 earnings were adversely affected by the mysterious loss of the S.S. MARINE SULPHUR QUEEN early in that year. In January 1964 TGS put into service a larger liquid sulphur cargo vessel to replace the lost vessel and announced the launching of the world's largest liquid sulphur tanker, which would make it possible to ship liquid sulphur to Europe, and on February 8, 1964 it announced plans to increase its Canadian production of sulphur by 500 tons per day.

Apart from its primary sulphur business, TGS was engaged in a diversification program in other fields, such as phosphate, potash, trona, oil and gas. Its entry into the phosphate and potash fields was important because phosphate, potash and sulphur are the three basic components of fertilizers. On November 15, 1963, TGS announced the creation of a new division for its phosphate project and that its potash mine was near completion and was scheduled

to go into production in the spring of 1964. On December 16, 1963, TGS announced that it had acquired the Canadian oil and gas properties of Delhi-Taylor Oil Company, and on April 3, 1964 announced plans (5441) to proceed with a 3,000,000 ton-per-year phosphate program in North Carolina at a cost of $45,000,000.

TGS had been engaged in exploration for sulphide deposits on the Canadian Shield since 1957 and in 1963-64 undertook exploratory work on the Kidd 55 segment in Kidd Township near Timmins, Ontario, which is more fully described hereafter.

The Individual Defendants

The individual defendants are directors, officers and employees of TGS as follows:

Defendant	Position
Claude O. Stephens	President and Director
Charles F. Fogarty	Executive Vice President* and Director
Thomas S. Lamont	Director
Francis G. Coates	Director
Harold B. Kline	Vice President and General Counsel**
Richard D. Mollison	Vice President
David M. Crawford	Secretary***
Richard H. Clayton	Engineer
Walter Holyk	Chief Geologist
Kenneth H. Darke	Geologist
Earl L. Huntington	Attorney
John A. Murray	Office Manager

* Prior to February 20, 1964 Mr. Fogarty was Senior Vice President.

** Prior to January 31, 1964 Mr. Kline was Vice President-Administration and Secretary.

*** Mr. Crawford was employed by TGS in January 1964 and became Secretary on February 20, 1964.

(5442) Defendant Thomas P. O'Neill was an accountant with TGS. He was served with a summons and complaint, but has failed to answer or appear. The Commission has moved for a default judgment against O'Neill in a separate proceeding. Therefore he is not referred to hereafter.

Summary of TGS's Exploratory Activities on the Kidd 55 Segment

Exploration on the Canadian Shield:

In 1957 TGS initiated an exploration program for sulphides[2] on the Canadian Shield, a vast area comprising most of eastern Canada. Much of the area is barren and flat with few outcroppings of rock and is covered with a swampy material known as muskeg. The subsurface structure consists of Pre-Cambrian rocks, dating from an early geologic time, and is complex and distorted.

(5443) Beginning in March, 1959, an exploration group—headed by defendant Mollison, a mining engineer, and consisting of defendant Holyk, the chief geologist; defendant Clayton, an electrical engineer and geophysicist; and defendant Darke, a geologist—conducted aerial geophysical surveys over more than 15,000 miles of the Canadian Shield area. Sulphides conduct electricity better than most other rock types and can be detected if they are in sufficient quantity and concentration and are not too deeply buried beneath the earth's surface.[3]

In the course of this aerial exploration, TGS detected several thousand anomalies—unusual variations in the conductivity of rocks. In the opinion of the exploration group several hundred of these anomalies were (5444) worthy of further investigation, and rights to land around them were

acquired. One of these anomalies, detected as early as 1959, was located near Timmins, Ontario, and was designated as the Kidd 55 segment. On June 6, 1963, TGS acquired an option to purchase the northeast quarter section (160 acres) of the Kidd 55 segment. Between November 8, 1963 and April 16, 1964 TGS drilled K-55-1, K-55-3, K-55-4, K-55-5, K-55-6, K-55-7 and K-55-10 at the locations shown on the accompanying Plan Map of the Kidd 55 segment.

Drill Hole K-55-1

On October 29 and 30, 1963, defendant Clayton conducted a ground geophysical survey on the northeast quarter section which confirmed the existence of the anomaly previously detected by the aerial survey. Defendant Clayton interpreted the survey as indicating three separate conductors of electricity tending in a north-south direction with an undetermined width and steep dip. Since the survey only *indicated the presence of conductive material* and not whether the material consisted of worthless or valuable minerals and since there was little geological evidence as to the makeup of the subsurface structure (the (5446) nearest outcroppings of rock were located more than 1,000 feet from the property), diamond core drilling was necessary for

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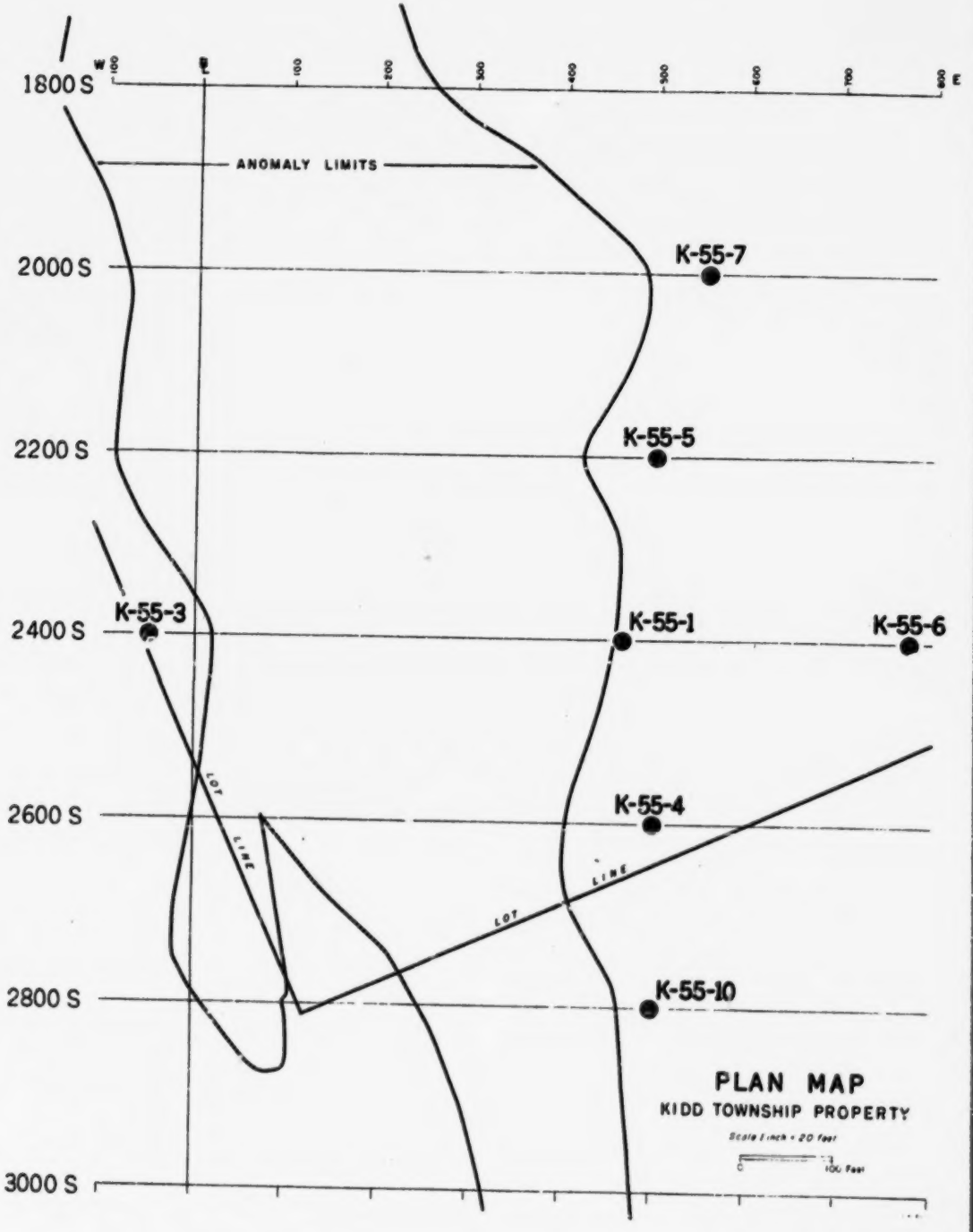
(5445)

Plan Map

KIDD TOWNSHIP PROPERTY

PHOTOPRINT
(Mounted Opposite)


1800 S
2000 S
2200 S
2400 S
2600 S
2800 S
3000 S
W
E
ANOMALY LIMITS
K-55-7
K-55-5
K-55-3
K-55-1
K-55-6
K-55-4
K-55-10
LOT LINE
LOT LINE
PLAN MAP
KIDD TOWNSHIP PROPERTY
Scale 1 inch = 20 feet
100 Feet

further evaluation of the anomaly. TGS had previously drilled 65 equally promising anomalies, but most of them had revealed either barren pyrite or graphite, while a few had shown marginal mineral deposits in insufficient quantities to be commercially mined.

On November 8, 1963, drilling of the initial hole (K-55-1) was begun on section line 2400 S. The location, direction, and angle of the hole were determined by defendants Holyk, Clayton and Darke, who considered the results of the geophysical survey and the location of property boundaries. The collar of the hole was placed about 60 feet to the east of the easternmost conductor, as interpreted by defendant Clayton, and at the strongest part of the anomaly. The hole was drilled westerly at an angle of 60 degrees in the hope that it would cut through all three conductors.

On November 12, 1963, drilling of K-55-1 was terminated at 655 feet. Defendant Holyk visually estimated that the core of K-55-1 indicated an average copper content of 1.15% and an average zinc content of 8.64% over a length of 599 feet. The percentages of copper and zinc (5447) mineralization at any given point in the core fluctuated markedly, but the copper mineralization appeared to be concentrated more on the eastern edge of the anomaly.

Property Acquisition

As a result of the visual examination of the core, TGS determined to acquire the three other quarter sections making up the Kidd 55 segment. Therefore, following the usual practice in the mining industry, security measures were put into effect. Further drilling on the anomaly was suspended and members of the exploration group were instructed to keep the results of K-55-1 confidential. The drill rig at the site of K-55-1 was moved away and cut sap-

lings were stuck in the ground in the area of the hole to conceal its location. A second drill hole (K-55-2) was drilled off the anomaly in order to produce a barren core.

The core from K-55-1 was split longitudinally and shipped to the Union Assay House, Salt Lake City, Utah, for chemical assay. In mid-December, TGS received reports from the assay which revealed an average metal content of approximately 1.18% copper and 8.26% zinc, as well as 3.94 ounces of silver per ton over a 602-foot length of the core. These were the only chemical assay reports on any drill hole which TGS received prior to April 16, 1964.

(5448) In the meantime, negotiations for the three other quarter sections comprising the Kidd 55 segment had been undertaken. TGS purchased one quarter-section outright for $7,500 and acquired options for $7,000 to purchase the other two for approximately $45,000. On March 27, TGS decided that the land acquisition program had advanced sufficiently to permit the company to resume drilling.

Drill Hole K-55-3

On March 31, the drilling of K-55-3 was commenced on section line 2400 S approximately 75 feet west of the western limits of the anomaly and approximately 510 feet west of K-55-1. It was drilled easterly at an angle of 45 degrees, and therefore crossed K-55-1 in a vertical plane on section 2400 S. K-55-3 was completed by 7:00 p.m. on April 7 and visual estimates of the core indicated an average copper content of 1.12% and an average zinc content of 7.93% over 641 feet of the hole's 876-foot length. Like K-55-1, K-55-3 indicated substantial copper mineralization on the eastern edge of the anomaly. Daily reports of the progress of K-55-3 and of the subsequent drill holes were made by defendants Mollison and Holyk to defendants Stephens and Fogarty.

(5449) *Drill Hole K-55-4*

On April 7, drilling of K-55-4 was commenced slightly to the east of the eastern edge of the anomaly on section line 2600 S, 200 feet to the south of K-55-1, and was drilled westerly on an angle of 45 degrees, parallel to K-55-1. By 7:00 p.m. on April 9, K-55-4 had encountered mineralization over 366 feet of its 420-foot length, but had entered a stretch of barren material at the 420-foot mark. The hole was completed to a length of 579 feet on April 10 at 7:00 p.m. without encountering further mineralization. Visual estimates of the 366 feet of mineralized core recovered from K-55-4 indicated an average copper content of 1.14% and an average zinc content of 8.24%. Like K-55-1 and K-55-3, K-55-4 encountered substantial copper mineralization on the eastern edge of the anomaly.

Drill Holes K-55-6 and K-55-5

On April 8, drilling of K-55-6 was commenced with a second drill rig[4] on section 2400 S, 300 feet to the east of K-55-1. It was drilled westerly at an angle of 60 degrees and was intended to explore mineralization beneath hole K-55-1. Due to the absence of geologists from the drill site on April 8 and 9,[5] nc immediate visual estimates of the core were available. It was apparent, (5450) however, by the evening of April 10 that the hole had encountered substantial copper mineralization over the last 127 feet of its 569-foot length.

On April 10, drilling of K-55-5 was commenced with a third drill rig on section 2200 S, 200 feet north of K-55-1. The hole was started on the eastern edge of the anomaly and was drilled westerly at an angle of 45 degrees, parallel to the holes previously drilled. By the evening of April 10, K-55-5 had been drilled 97 feet and, although no immediate visual estimates of the core were available, it was apparent

that the hole had intersected substantial copper mineralization over the last 42 feet of its length.

The results of drilling through the evening of April 10 were available to TGS when it issued its April 12 press release.

Core Drilling between 7:00 p.m. April 10 and 7:00 a.m. April 13

Drilling of K-55-5 and K-55-6 continued, and by the morning of April 13, K-55-5 had encountered mineralization to the 580-foot mark. It was subsequently drilled to a length of 757 feet without encountering further mineralization. Visual estimates of the core indicated that over a 525-foot section the drill hole had intersected an average (5451) copper mineralization of 0.82% and an average zinc mineralization of 4.2%. By 7:00 a.m. on April 13, K-55-6 had encountered mineralization to the 946-foot mark. It was subsequently drilled to a length of 1180 feet without intersecting any further mineralization. Visual estimates of a 504-foot section of the core indicated an average copper content of 1.72% and an average zinc content of 6.60%.

On April 12 drilling of K-55-7 was commenced with a fourth drill rig on section 2000 S at the eastern edge of the anomaly. It was drilled westerly at an angle of 45 degrees and by the morning of April 13 had encountered 50 feet of mineralization over the 137 feet drilled. The drilling of a mill test hole, K-55-8, was also commenced by April 11 and completed by the evening of April 13. The core was 2¼ inches in diameter as compared with the 1⅛ inch diameters of the other holes, and was intended to be used for metallurgical testing to determine the amenability to milling of the material that had been encountered. No geologist's log or visual estimates were made of K-55-8 and no metallurgical tests of the core were reported prior to April 16.

(5452) *Core Drilling between 7:00 a.m. April 13 and 7:00 p.m. April 15*

On April 14 drilling of K-55-10 was commenced on section 2800 S on the eastern edge of the anomaly and was drilled westerly at an angle of 45 degrees. By 7:00 p.m. on April 15, it had encountered mineralization over the last 231 feet of the 249 feet of drilling. Drilling of K-55-7 was completed to a length of 707 feet, but encountered only 26 more feet of mineralization between the 425-foot and the 451-foot marks.

PURCHASE OF TGS STOCK AND CALLS ON TGS STOCK BY CERTAIN DEFENDANTS AND "TIPPEES" BETWEEN NOVEMBER 12, 1963 AND APRIL 16, 1964

The evidence established that all of the individual defendants except Stephens and Kline purchased shares of TGS and/or calls on TGS stock between November 12,
(5453) 1963, when the first drill hole on the Kidd property was completed (K-55-1), and the close of business on April 16, 1964, the day on which TGS issued a press release announcing the discovery of a copper mine on the Kidd 55 segment at a press conference called for the purpose. The evidence also shows that certain persons who were referred to by counsel at the trial as "tippees" purchased shares of TGS and/or calls on TGS stock on the basis of advice received directly or indirectly from defendants Darke, Coates and Lamont. The following table lists these purchases (including those of defendant Holyk's wife), but does not include the shares covered by stock options granted by TGS to certain defendants on February 20, 1964.

(5454)

Purchase Date	Purchaser	Shares		Calls	
		Number	Price	Number	Exercise Price
HOLE K-55-1 COMPLETED NOVEMBER 12, 1963					
1963					
Nov 12	Fogarty	300	17¾-18		
15	Clayton	200	17¾		
15	Fogarty	700	17⅝-17⅞		
15	Mollison	100	17⅞		
19	Fogarty	500	18⅛		
26	Fogarty	200	17¾		
29	Holyk (Mrs.)	50	18		
CHEMICAL ASSAYS OF DRILL CORE OF K-55-1 RECEIVED DECEMBER 9-13, 1963					
Dec 10	Holyk (Mrs.)	100	20⅜		
12	Holyk (or wife)			200	21
13	Mollison	100	21⅛		
30	Caskey*			300	22¼
30	Fogarty	200	22		
31	Fogarty	100	23¼		
1964					
Jan 6	Holyk (or wife)			100	23⅝
8	Murray			400	23¼
16	Westreich*	2000	21¼-21¾		
24	Holyk (or wife)			200	22¼-22⅜
Feb 10	Fogarty	300	22⅛-22¼		
17	Atkinson*	50	23¼	200	23⅛
17	Westreich*	50	23¼	1000	23¼-23⅝
20	Darke	300	24⅛		
24	Clayton	400	23⅞		
24	Holyk (or wife)			200	24⅛
24	Miller*			200	23¾
25	Miller*			300	23⅜-23½
26	Holyk (or wife)			200	23⅜
26	Huntington	50	23¼		
27	Darke (Moran as nominee)			1000	22⅝-22¾
Mar 2	Holyk (Mrs.)	200	22⅜		
3	Clayton	100	22¼		
3	E. W. Darke*			500	22½-22⅝
16	Huntington			100	22⅜
16	Holyk (or wife)			300	23¼
17	Holyk (Mrs.)	100	23⅞		
17	E. W. Darke*			200	23⅜
23	Darke			1000	24¾
26	Clayton	200	25		

(5455)

Purchase Date	Purchaser	Shares Number	Shares Price	Calls Number	Calls Exercise Price
LAND ACQUISITION COMPLETED MARCH 27, 1964					
Mar 30	Atkinson*			400	25¾-25⅞
30	Caskey*	100	25⅞	1000	25¾-25⅞
30	Darke			1000	25½
30	E. W. Darke*			200	25½
30	Holyk (Mrs.)	100	25⅞		
30-31	Klotz*			2000	25½-26⅛
30	Miller*			500	25½-25⅞
30	Westreich*	500	25¾		
CORE DRILLING OF KIDD 55 SEGMENT RESUMED MARCH 31, 1964					
Apr 1	Clayton	60	26½		
1	Fogarty	400	26½		
2	Clayton	100	26⅞		
6	Fogarty	400	28⅛-28⅞		
8	Mollison (Mrs.)	100	28⅛		
421 FEET KIDD-55-4 COMPLETED APRIL 9, 1964, 7 P.M.					
TGS PRESS RELEASE ISSUED APRIL 12, 1964					
Apr 15	Clayton	200	29⅜		
16	Crawford (and wife)	600	30⅛-30¼		
TGS PRESS RELEASE AND PRESS CONFERENCE APRIL 16, 1964, 10 A.M.					
Apr 16	Coates (for family trusts)	2,000	31-31⅝		
16	Haemisegger**	300	32½		
16	Robt. L. Armstrong**	200	31¼-34½		
16	Charles Callery**	300	32½		
16	James A. Baker III**	200	32⅝		
16	Malcolm G. Baker Jr.**	500	34½-35		
16	Morgan Guaranty Trust Co.***	10,000	32⅝-34		
16	Lamont and family****	3,000	34½		

* Darke visited Mrs. Caskey and her daughter Miss Atkinson in Washington between Dec. 25 and Dec. 30, 1963 and recommended TGS. They in turn recommended TGS directly or indirectly to others marked with *, with the exception of E. W. Darke, Darke's brother, who purchased calls on Darke's recommendation.

** Purchased by Haemisegger, Coates' son-in-law, for himself and customers (**) following telephone call from Coates before 10:20 a.m.

*** Purchased for its customers' accounts following call from Lamont to Hinton at about 10:40 a.m.

**** Purchased through Morgan Guaranty Trust Co. after 12:33 p.m.

(5456) THE SECURITIES EXCHANGE ACT OF 1934 (THE ACT) AND RULE 10B-5

The Commission has instituted this action pursuant to Section 27 of the Act (15 U.S.C. 78aa) which confers upon the District Courts of the United States exclusive jurisdiction of violations of the Act or of the rules and regulations promulgated thereunder and of "all suits in equity and actions at law brought to enforce any liability or duty created by" the Act or the rules and regulations thereunder.

The preamble of the Act states that it is "to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."

Section 2 (15 U.S.C. 78b) provides that:

> ". . . transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, . . . and to impose requirements necessary to make such regulation and control reasonably complete and effective, (5457) in order to protect interstate commerce . . . and to insure the maintenance of fair and honest markets in such transactions. . . ."

Section 2(2) (15 U.S.C. 78b(2)) provides:

> "The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold. . . ."

Section 2(3) (15 U.S.C. 18b (3)) states that:

> "Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control. . . ."

Section 4(a) (15 U.S.C. 78d(a)) provides for the establishment of the Commission as the agency charged with the administration of the Act.

Section 10 of the Act (15 U.S.C. 78j) provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

(5458) Pursuant to the authority conferred on the Commission by Section 10(b), in May, 1942 the Commission

promulgated Rule 10b-5 (17 C.F.R. 240; 10b-5), which provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

In Rule 10b-5 the Commission adapted the language of Section 17(a) of the Securities Act of 1933 (15 U.S.C. 77q) relating to fraudulent interstate transactions. Similar language was also used in Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6).[6]

The Commission has the responsibility of administering the Act and of securing compliance therewith. To carry out this responsibility, it has been given, among other powers, authority under Sections 21(e) and 27 (15 U.S.C. 78u, 78aa) to institute actions in the district courts to (5459) enjoin existing or prospective violations of the Act and to enforce any liability or duty created by the Act or the rules and regulations promulgated pursuant thereto. The Commission contends that the defendants engaged in a "course of

business" which operated "as a fraud or deceit" on the stockholders of TGS in violation of Section 10(b) and Rule 10b-5.[7]

The defendants assert that the Commission must establish the elements of common law fraud—misrepresentation or nondisclosure, materiality, scienter, intent to deceive, reliance, and causation—citing decisions in private actions brought under Section 10(b) requiring proof of one or more of these traditional elements as a condition precedent to relief. *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783, 786 (2d Cir. 1951) ("proof of fraud is required in suits under §10(b) of the 1934 Act. . . ."); *Weber* v. *C.M.P. Corporation*, 242 F. Supp. 321, 324 (S.D.N.Y. 1965) (scienter); *Barnett* v. *Anaconda Company*, 238 F.Supp. 766, 771 (S.D.N.Y. 1965) (causation). See, Comment, "Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity," 74 *Yale L. J.* 658 (1965).

(5460) However, recent decisions, even in private suits, do not require proof of these elements in actions charging violations of Rule 10b-5. *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210 (9th Cir. 1962); *Ellis* v. *Carter*, 291 F. 2d 270 (9th Cir. 1961). In *Stevens* v. *Vowell*, 343 F. 2d 374, 379 (10th Cir. 1965), the court stated:

> "It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact."

In a regulatory or enforcement proceeding under Section 27 of the Act, the Commission is not required to prove these common law elements. In *S.E.C.* v. *Capital Gains Bureau*, 375 U.S. 180 (1963), the defendant was an invest-

ment advisor who published a monthly report, mailed to approximately 5,000 customers, which recommended certain securities for long term investment. Before mailing the report, the defendant would purchase the recommended securities on the market and when the price rose after customers received the report, defendant would sell at a profit. The Commission sought an injunction under Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6) (8) (5461) to compel defendant to disclose this practice to customers. The district court denied a preliminary injunction on the ground that "fraud" was used in the Investment Advisers Act of 1940 in its technical common law sense and that the Commission had failed to establish an intent to injure clients or an actual loss to clients. (191 F. Supp. 897, 898.) The Second Circuit Court of Appeals, sitting *en banc,* affirmed the district court by a 5-to-4 vote. (306 F. 2d 606.)

In reversing, the Supreme Court held that:

> "It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit,' intended to require proof of intent to injure and actual injury to clients. (375 U.S., at 192.)
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> "Congress intended the Investment Advisers Act of 1940 to be *construed like other securities legislation* 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes. (375 U.S., at 195.) (Emphasis supplied)

Since there is a direct parallel between the language of Rule 10b-5(3) and Section 206 of the Investment Advisers Act of 1940, both in wording and in intent, the use of "fraud" in Rule 10b-5(3) cannot be interpreted in its narrow common (5462) law sense. *Cf., Berko* v. *Securities and Exchange Commission,* 316 F. 2d 137 (2d Cir. 1963).

The suggestion made by the defendants that Section 16 of the Act (15 U.S.C. 78p), relating to directors, officers, and principal stockholders, defines "insiders" and limits the liabilities of insiders to the sanctions provided in Section 16, is equally without merit. A Section 16 action can be brought only by the corporation itself or derivatively by an existing security holder against officers, directors or beneficial owners of ten per cent or more of the corporation's listed equity securities. It covers only short-swing profits realized within a six-month period, and any recovery inures to the corporation. Profits are recoverable regardless of any intent to defraud and without proof that they were realized by reason of inside information. In short, Section 16 was enacted as a "crude rule of thumb" to make unprofitable all short-swing speculation by a specifically defined group of insiders. See, *Blau* v. *Lamb,* F. 2d (2d Cir., June 27, 1966).

A Section 10(b) action, on the other hand, may be brought pursuant to Section 27 by the Commission or by any party claiming to have been defrauded. The section (5463) applies to "any person," not merely to the persons encompassed by Section 16. *H. L. Green Co.* v. *Childree,* 185 F. Supp. 95 (S.D.N.Y. 1960) (accountants); *Cady, Roberts & Co.,* 40 S.E.C. 907 (1961) (broker). Section 16 requires both a purchase and a sale of a listed security, while Section 10(b) applies to a purchase or sale of any security. The numerous differences between Section 16 and Section

10(b) clearly indicate that the provisions of the former impose no limitation on the enforcement of the latter. See, 3 Loss, *Securities Regulation,* 1473, 1474 (2d ed. 1961); Comment, "The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors," 59 *Yale L. J.* 1120, 1140-42 (1950).

To establish violations of Section 10(b) and Rule 10b-5(3), the Commission must prove that the defendants engaged in a "course of business" which operated as a "fraud or deceit . . . in connection with the purchase or sale of any security." Questions arise therefore as to whether insider purchases based on material, undisclosed information constitute violations of Section 10(b) and Rule 10b-5(3); if so, who are insiders; whether the statute and rule are limited to "face-to-face" transactions; and, finally, what constitutes material information.

(5464) The statute and rule go at least as far as the federal common law rule. *List* v. *Fashion Park, Inc.,* 340 F.2d 457, 461-2 (2d Cir. 1965). As long ago as 1909, the Supreme Court held in *Strong* v. *Rapide,* 213 U.S. 419 (1909), that the failure of the director and general manager of a corporation to disclose "special facts" in purchasing its securities operated as a fraud on the seller. The Court stated that:

> "If it were conceded, for the purpose of the argument, that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company before he purchases any from a shareholder, yet there are cases where, by reason of the special facts, such duty exists." 213 U.S., at 431.

Applying this "special facts" doctrine to Section 10(b) and Rule 10b-5, trading by an insider on the basis of material undisclosed information constitutes a deceptive practice in violation of the statute and rule. See, Loss, *supra,* at 1445-73.

In *Strong* v. *Rapide,* the defendant was a director and general manager of the corporation, and owned three-fourths of its outstanding shares. He was, therefore, an (5465) insider under any standard. Section 10(b) has been construed as imposing a similar liability on officers, directors, and major stockholders. *Cochran* v. *Channing Corporation,* 211 F. Supp. 239 (S.D.N.Y. 1962). Further, since Section 10(b) applies to "any person" it can include "insiders" who are not officers, directors or major stockholders. *Cady, Roberts & Co., supra,* at 912.

In *Brophy* v. *Cities Service Co.,* 70 A. 2d 5, 7 (Del. Ch. 1949), the court pointed out "if an employee in the course of his employment acquires secret information relating to his employer's business, he occupies a position of trust and confidence toward it, analogous in most respects to that of a fiduciary, and must govern his actions accordingly."

Citing *Brophy,* the Commission in *Cady, Roberts & Co., supra,* found that the obligation to disclose material information rests on two grounds:

> ". . . first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing." 40 S.E.C., at 912.

(5466) Therefore, insiders subject to the disclosure requirements of Section 10(b) and Rule 10b-5 may include employees as well as officers, directors, and controlling stockholders who are in possession of material undisclosed information obtained in the course of their employment.

An insider's liability for failure to disclose material information which he uses to his own advantage in the purchase of securities extends to purchases made on national securities exchanges as well as to purchases in "face-to-face" transactions. *List* v. *Fashion Park, Inc., supra,* at 461-62. In *Cochran* v. *Channing Corporation, supra,* at 243, the court stated:

> "The Securities Exchange Act was enacted in part to afford protection to the ordinary purchaser or seller of securities. Fraud may be accomplished by false statements, a failure to correct a misleading impression left by statements already made or, as in the instant case, by not stating anything at all when there is a duty to come forward and speak. It is the use of inside information that gives rise to a violation of Rule 10b-5. [Citations omitted.] Lack of communication between defendant and plaintiff does not eliminate the possibility that Rule 10b-5 has been violated."

And, as noted in *Cady, Roberts,* "it would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, (5467) primary markets for securities transactions." 40 S.E.C., at 914.

In response to the defendants' contention that it would be impossible for an insider trading on a national exchange

to seek out the other party to the transaction and disclose material information to him (*Goodwin* v. *Agassiz,* 186 N.E. 659 (Mass. 1933)), it is clear that there are other ways of disclosing significant corporate developments. The New York Stock Exchange provides in its *Company Manual* that "important developments which might affect security values or influence investment decisions should be promptly disclosed." (Listing Agreement at A-20.) If legitimate business reasons require a period of non-disclosure, the insider should forego transactions in his company's securities during that period. *Cady, Roberts, supra,* at 911. As stated by the court in *Oliver* v. *Oliver,* 45 S.E. 232, 234 (Ga. 1903):

> "It might be that the director was in possession of information which his duty to the company required him to keep secret; and, if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his (5468) own advantage, and to the disadvantage of one whom he also represents. The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known."

However, to establish a violation of Section 10(b) and Rule 10b-5, the undisclosed information must be material. *List* v. *Fashion Park, Inc., supra.* There is nothing in the Act which precludes insiders from purchasing stock of their company or from being beneficiaries of the company's incentive stock option plan. On the contrary, it is important,

under our free enterprise system that insiders, including directors, officers, and employees, be encouraged to own securities of their company. The incentive that comes with stock ownership benefits both the company and its stockholders.

Moreover, it is obvious that any director, officer, or employee will know more about his company or have more specialized knowledge as to at least some phase of its business than an outside stockholder can have or expect to have. Often this specialized knowledge may whet the speculative interest of the insider, particularly if he believes in the future of his company, and may lead him to purchase stock. Purchases under such circumstances are not encompassed by Section 10(b) and Rule 10b-5. As stated (5469) in Loss, *supra,* at 1463:

> ". . . an insider is under no obligation to give the ordinary investor the benefit of his superior financial analysis. It has been aptly said that, 'Even though a shrewd guess by an insider is often worth fifty accounting statements, it would be highly unfair to make him publicize his guess and then to hold him responsible if it turns out to be wrong.' " (Quoting, Comment, "The Prospects for Rule X-10b-5," 59 *Yale L. J.,* at 1148.)

However, where an insider comes into possession of *material* information which he uses to his own advantage by purchasing stock or calls on the stock of his company prior to public disclosure, he violates Section 10(b) and Rule 10b-5. Information is not material merely because it would be of interest to the speculator on Bay Street or Wall Street. Material information has been defined as information "which in reasonable and objective contemplation

might affect the value of the corporation's stock or securities. . . ." *List* v. *Fashion Park, Inc., supra,* at 462, citing, *Kohler* v. *Kohler Co.,* 319 F. 2d 634, 642 (7th Cir. 1963). It is information which, if known, would clearly affect "investment judgment," *Cady, Roberts, supra,* at 911, or which directly bears on the intrinsic value of a company's stock. See, *Kardon* v. *National Gypsum Co.,* 73 F. Supp. 798 (E.D. Pa. 1947); *Speed* v. *Transamerica Corp.,* 99 F. Supp. 808 (5470) (D. Del. 1951); *Ward LaFrance Truck Corp.,* 13 S.E.C. 373 (1943).

Material information need not be limited to information which is translatable into earnings, as suggested by defendants. But the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight. As stated by a former member of the staff of the Commission:

> "It is appropriate that management's duty of disclosure under rule 10b-5 be limited to those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed. A more rigorous standard would impose an unreasonable burden on management in its securities trading. Moreover, such a standard could involve the courts to an unrealistic degree in the determination of whether certain types of information might have an impact on the market. A finer web might well prevent some management trading that represents an abuse, but only at the cost of possibly exposing management to meritless litigation in many other cases." (Fleischer, 'Securities Trading and Corporate Information Practices: The Implications of the *Texas Gulf Sulphur* Proceeding,' 51 *Va. L. Rev.* 1271, 1289 (1965).)

(5471)

APPLICATION OF SECTION 10(b) OF THE ACT AND RULE 10b-5 TO PURCHASES BY INDIVIDUAL DEFENDANTS

All of the individual defendants were directors, officers or employees of TGS. With the exceptions of Stephens and Kline, each purchased stock of TGS using the facilities of a national securities exchange. Accordingly, the jurisdictional requirements of the Act and Rule 10b-5 have been satisfied with respect to these purchases. The issue remains as to whether any of the defendants in purchasing TGS stock or calls on TGS stock were using for their own advantage material information as to the drilling on the Kidd 55 segment not disclosed to the public. Defendants Huntington and Murray had no detailed knowledge as to the work and hence were not in possession of material information. Huntington knew only that TGS was acquiring property rights in Kidd Township. Murray had no knowledge of the situation on the Kidd 55 segment at the time he made his purchases. In considering whether the remaining individual defendants were in possession of material information when they made their purchases, the period from November 12, 1963 to April 16, 1964 may be conveniently subdivided as follows:

(1) November 12, 1963 to 7:00 p.m. April 9, 1964

(2) 7:00 p.m. April 9 to 10:00 a.m. April 16, 1964

(3) April 16, 1964 from 10:00 a.m. to the close of business on that day.

(5472)

(1) *November 12, 1963 to 7:00 p.m. April 9, 1964*

K-55-1 was completed on November 12, 1963. Visual estimates at the drill site, which were subsequently confirmed

by chemical assays received in mid-December, indicated substantial zinc and copper mineralization over approximately 600 feet of the core's 657 foot length. On the basis of the visual estimates, TGS took customary security measures to maintain the secrecy of the drilling results while it undertook to acquire the remaining quarter sections of the Kidd 55 segment. On March 31, 1964 drilling was resumed.

K-55-3 was drilled and established that mineralization existed in a vertical plane over 350 feet wide and 500 feet deep. On April 7 drilling of K-55-4 was begun 200 feet south of K-55-1 and by 7:00 p.m. on April 9 it had been drilled to 421 feet and had encountered 366 feet of mineralization. K-55-1, K-55-3, and K-55-4 intersected substantial copper mineralization on the eastern edge of the anomaly.

According to the Commission's experts, Adelstein[9] (the Commission's chief mining engineer) and Pennebaker (consulting geologist to the Commission), K-55-4 established a third dimension to the mineralized zone, so that the (5473) drilling through 7:00 p.m. on April 9 established a mine.[10]

The geologists called by the defendants disputed the conclusions reached by Adelstein and Pennebaker, unanimously agreeing that the drilling of the three holes to 7:00 p.m. on April 9 did not establish that TGS had a mine. The Commission has taken the position with respect to registration statements filed under the Securities Act of 1933 that "three diamond drill holes are insufficient to determine whether a commercial ore body is present, even though they should encounter a gold bearing structure." *Pan-American Gold Ltd.*, 31 S.E.C. 141, 147-8 (1950).

It is unnecessary to determine whether TGS had a mine since the drilling of K-55-4 to 7:00 p.m. on April 9 was a strong indication that the mineralization encountered on the vertical plane between K-55-1 and K-55-3 extended southward 200 feet. There was real evidence that a body

of commercially mineable ore might exist. At 7:00 p.m. on April 9, those with knowledge of the drilling results had material information which it was reasonably certain, if disclosed, would have had a substantial impact on the market price of TGS stock. Therefore, they were under a duty not to use such material information to their personal advantage without first disclosing it to the public.

(5474) However, the drilling results up to 7:00 p.m. on April 9 did not provide such material information. When considered in relation to the far-flung business of TGS at the time, it cannot be said that the drilling results of K-55-1 and K-55-3 constituted material information, the disclosure of which would have had a substantial impact on the market price of TGS's 10,000,000 outstanding shares.

K-55-1

There is no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it. However, all the experts agreed that one drill core does not establish an ore body, much less a mine. Defendants' experts unanimously concluded that there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body. Concededly, the geophysical survey conducted prior to the drilling of K-55-1 indicated a "first class" anomaly over a length of more than 1,000 feet, but the conductive materials evidenced by the survey outside the first drill hole could have consisted of worthless pyrite or graphite, both of which materials were found in the core of K-55-1. As stated by Boniwell, a mining geophysicist, (5475) geophysics is of little help in predicting continuity.

Moreover, the core of K-55-1 was not solid ore. The percentages of copper and zinc mineralization fluctuated

markedly. Although it appears this is not unusual due to the complex nature of the Pre-Cambrian subsurface rock structure, it supports the testimony of defendants' experts that no predictions could be made as to how far mineral values encountered by K-55-1 extended beyond the 1⅛ inch drill core. As was brought out by Walkey, a mining engineer employed by Kamkotia Mines 12 miles from the Kidd 55 segment, mineral deposits on the Canadian Shield tend to be highly irregular in structure, with wide variations in grade. Walkey, Boniwell and Wiles (a mining engineer with forty years' experience) testified as to instances where one drill hole had produced a promising core but subsequent drilling had shown that the mineral values did not extend any appreciable distance beyond that core. Therefore, the first promising core may turn out to be a liability by inducing further drilling with negative results.[11]

Bellemore and Pearson, security analysts called by defendants, testified that from an investment point of (5476) view no significance could be attached to the results of a single drill hole, however rich.

The most that can be said of the individual defendants' knowledge after the drilling of K-55-1 is that they had "hopes, perhaps with some reason," that it would lead to a mine. *James Blackstone Mem. Lib. Ass'n* v. *Gulf, M. & O. R. Co.*, 264 F. 2d 445, 450 (7th Cir. 1959). The results of K-55-1 were too "remote" when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, *i.e.*, to be deemed material. *List* v. *Fashion Park, Inc., supra.*

The Commission contends, however, that the results of K-55-1 were material because of the significance attached to

those results by certain defendants. Between the completion of K-55-1 on November 12, 1963 and the completion of K-55-3 on April 7, 1964, defendants Fogarty, Mollison, Holyk, Clayton and Darke spent more than $100,000 in purchasing stock and calls on the stock of TGS. These defendants could bring considerable expertise to bear in evaluating the results of K-55-1 and their purchases may have been prompted by an educated guess that K-55-1 would (5477) lead to the discovery of a mine. Therefore, a question is presented as to whether information which may have special significance to an insider because of his professional background, is material.

A similar question would be presented where an engineer in the research department of a publicly-held corporation believes that he may have invented a process which will substantially increase the corporation's earnings or where a chemist in a large pharmaceutical firm thinks that he may have devised a chemical formula which can cure cancer. In these instances it can be assumed that the insider, because of his educated guess, will be enthusiastic and his enthusiasm may lead him to purchase stock in his company and to recommend the stock to his associates and friends even though his educated guess may turn out to be wrong. It may be argued that such purchases are "unfair" to the outside stockholders and come within the ambit of Section 10(b) and Rule 10b-5. Purchases on the basis of educated guesses may be viewed as an attempt to secure additional corporate compensation. Cary, "Corporate Standards and Legal Rules," 50 *Calif. L. Rev.* 408 (1962).

(5478) However, most insiders necessarily have educated guesses about the prospects of particular company programs. If it is held that purchases made on the basis of educated guesses are proscribed by Section 10(b) and Rule

10b-5, insiders who purchase stock in their company will do so at their peril. If they announce their educated guesses before purchasing and their guesses turn out to be wrong, they would be subject to suit; and if they purchase and keep their educated guesses to themselves and they turn out to be right, they would again be subject to suit. The creation of such a dilemma would result in insiders not buying at all although insiders should be encouraged to have a stake in the companies for which they work.

The outside stockholder can never match the knowledge of an insider who necessarily knows more about the company and is in a better position to evaluate its prospects. It may be that the "fairness" overtones of *Cady, Roberts* indicate a trend toward the elimination of all insider purchasing. But even were the Court prepared to accept the proposition that all insider trading is unfair, a proposition of doubtful validity at best, it would be deterred by the admonition of Judge Learned Hand that it is not "desirable for a lower (5479) court to embrace the exhilarating opportunity of anticipating a doctrine which may be in the womb of time, but whose birth is distant. . . ." *Spector Motor Service Inc.* v. *Walsh,* 139 F. 2d 809, 823 (2d Cir. 1944) (dissenting opinion) (reprinted in Bar Bulletin, N. Y. Co. Lawyers Assn, Vol. 23, No. 4, at 156, 1965-66). Therefore the purchases prior to 7:00 p.m. on April 9 were not based on material undisclosed information even if the purchasers had educated guesses based on the results of the first drill hole.

K-55-3

K-55-3 established that K-55-1 had not gone down dip, and indicated a vertical plane on section 2400 S containing mineralization. However there was no indication that the

mineralization extended beyond the plane. Defendant Mollison testified that at Kamkotia a drill hole could produce substantial mineralization while another 50 feet away produced a barren core. The results of K-55-3 added to the information previously known but did not constitute material information. If disclosed, it would not have had a substantial impact on the market price of the Company's stock.

Accordingly, the purchases made by certain defendants prior to 7:00 p.m. on April 9, 1964 were not based (5480) on material information. The fact that subsequent drilling established a major ore body is immaterial. As stated recently in *Value Line Fund, Inc.* v. *Marcus,* CCH FED. SEC. L. REP. ¶91,523,, at 94,956 (S.D.N.Y. 1965), "the court must be guided not by hindsight, but by the facts as they existed at the time of the . . . challenged transaction."

Similarly, purchases by Darke's "tippees" prior to 7:00 p.m. on April 9 were not made on the basis of material undisclosed information. Toward the end of December, 1963, Darke visited Caskey and Atkinson in Washington. The evidence shows no more than that Darke indicated to them that he thought TGS was a good buy. There is no direct evidence that Darke again communicated with any of his "tippees," but the record shows that on March 30, 1964 Darke and his "tippees," Atkinson, Caskey, E. W. Darke, Klotz, Miller and Westreich, purchased substantial amounts of TGS stock and calls on TGS stock. As the Commission points out, this is strong circumstantial evidence that Darke must have passed the word to one or more of his "tippees" that drilling on the Kidd 55 segment was about to be resumed. But, for the reasons hereinbefore stated, this information was not material.

(5481) For the foregoing reasons, the Court finds no violations of Section 10(b) or Rule 10b-5 on the part of any of the individual defendants who purchased shares of TGS or calls on TGS stock or recommended such purchases to others prior to 7:00 p.m. on April 9, 1964.

(2) *7:00 p.m. April 9, 1964 to 10:00 a.m. April 16, 1964*

Defendant Clayton purchased 200 shares of TGS stock on April 15; defendant Crawford purchased 600 shares on April 16. These defendants (and defendants Coates and Lamont) raise the defense that even if they were in possession of material information when they made their purchases, the material information had already become a matter of public knowledge.

The trial developed that rumors of an ore discovery by TGS were flying around Canada during the early part of April and were being given wide circulation in the Canadian press. These rumors reached the New York press by April 11, on which day they were played up in both the *New York Times* and the *New York Herald Tribune.* At this point defendants Stephens and Fogarty agreed that a press release was necessary and this decision led to the issuance of the April 12 press release hereafter discussed. Fogarty (5482) also gave instructions that a reporter from *The Northern Miner* (an important Canadian publication on the mining industry in Canada), who had previously been invited to visit the Kidd 55 segment on April 21, be asked to come on April 13 instead.

The Northern Miner reporter, Ackerley, visited the property on April 13, interviewed defendants Mollison, Holyk and Darke, looked at the records of the drilling to that time, and prepared an article for publication. The article stated in part that "The Northern Miner can say that a

major new zinc-copper-silver mine is definitely in the making, one that has all the earmarks of shaping into a substantial open pit operation . . . something in excess of 10,000,000 tons of ore is indicated." Ackerley delivered a copy of his proposed article to defendant Mollison in Timmins and it was agreed that it would not be published until cleared by Mollison. Defendants Mollison and Holyk read the article and though they felt that some of its conclusions were too optimistic, they considered it Ackerley's article and would not quibble with it. Defendant Mollison returned the article to *The Northern Miner* on the evening of April 15, and it was published in *The Northern Miner's* April 16 edition.

(5483) *The Northern Miner* had a small circulation in the United States—7,400 subscribers—including distribution in the New York area to 1,412 subscribers, who presumably received the paper on the morning of April 16. *The Northern Miner* also had a small newsstand circulation in New York, but the evidence fails to establish when the April 16 edition reached the newsstands. Reports of *The Northern Miner* article were telephoned and telexed from Toronto to some brokers in New York early on the morning of April 16 prior to the opening of the New York Stock Exchange.

The annual convention of the Canadian Institute of Mining and Metallurgy was held at the Queen Elizabeth Hotel in Montreal on April 13-15, attended by 500 to 600 representatives of the mining industry and of the business world, including some representatives from the United States. The rumors with respect to a copper discovery by TGS near Timmins were a leading subject of gossip in the corridors and bars of the hotel. The convention was attended by the Ontario Minister of Mines and his Deputy.

On the morning of April 15, defendants Mollison and Holyk met the Minister of Mines and his Deputy at the (5484) Montreal airport and flew them to Toronto, informing them during the course of the flight of the current developments on the Kidd 55 segment. The Minister indicated a desire to make a public statement and Mollison assisted him by drafting that statement. Mollison's draft concluded by saying that "the information now in hand . . . gives the company confidence to allow me (the Minister) to announce that TGS has a minable body of Zn, Cu, Ag ore of substantial dimensions that will be developed and brought to production as rapidly as possible." Mollison and Holyk were under the impression that the Minister would issue the statement in Toronto over radio and television at 11:00 p.m. on the evening of April 15 and Mollison so informed defendants Stephens and Fogarty in New York.

The Minister made no announcement on the evening of the 15th, but on the morning of the 16th, at about 9:40 a.m., he delivered the statement drafted by Mollison to the press gallery at the Ontario Parliament in Toronto. Members of the press gallery included representatives of both the Canadian and American news media, but there was no evidence as to who was in the press gallery at the time.

The effect of the foregoing was that before the market opened on April 16, some brokers and some speculators (5485) had picked up information that TGS had made an ore discovery. However, no announcement had yet been made by TGS. Only the day before, defendants Stephens, Fogarty and Crawford were preparing the announcement which was to be made at 10:00 a.m. on April 16. They took steps to assure the attendance of appropriate representatives of the news media at the press conference where the announcement would be made. The officers of TGS knew

about the rumors in Canada, the *Northern Miner* article and the pending announcement of the Ontario Minister of Mines. Had they thought that their effect was to make the material information public there would have been little purpose in making the arrangements for a press conference, and issuing a detailed announcement on April 16. The material information did not become public knowledge prior to TGS's official announcement. Therefore, insiders who purchased stock prior to TGS's announcement may not assert as a defense that the material information had already become a matter of public knowledge.

Turning now to the two defendants who purchased shares of TGS after 7:00 p.m. on April 9, 1964 and before 10:00 a.m. on April 16:

Richard H. Clayton

Clayton was a geophysicist in the employ of TGS. His job was to conduct geophysical surveys, and he conducted such surveys on the Kidd anomaly. While he did not participate (5486) in the drilling, he spent a great deal of his time at Timmins and at the Kidd 55 segment, and the evidence establishes that he kept himself fully informed. He was in Timmins on April 12 and 13 and, according to Adelstein, he told Adelstein (on June 3, 1964) that he thought TGS had a mine when he learned the results of K-55-4. While Clayton denied making this statement, he testified at a pre-trial examination that he thought that, with the results of K-55-6, TGS had a potential ore body. By 7:00 p.m. on April 13, K-55-6 had been drilled to 949 feet, encountering substantial mineralization. Indeed, no further mineralization was encountered by K-55-6 after that time. On April 14 Clayton left for New York and was in TGS's New York

office on April 15. He picked up the telephone at TGS's office in New York, called his broker in Toronto and ordered 200 shares of TGS stock. The broker executed the order on April 15 on the Midwest Stock Exchange in Chicago at 29⅜.

It is clear that at the time of this purchase Clayton was in possession of material inside information which had not yet been made available to the public and that he used this information to his own advantage. In this proceeding by the Commission it is immaterial whether (5487) Clayton intended to deceive or to defraud anyone or whether he knew at the time that his purchase would violate Section 10(b) and Rule 10b-5. The Commission has established that Clayton violated these provisions in making his April 15 purchase.

Clayton contends that he is not subject to the jurisdiction of this court. He was employed by TGS, a United States corporation, and, according to his testimony, shuttled back and forth between Canada and New York on TGS business during the period from November 1963 to April 1964. His April 15 purchase was initiated by him while he was in New York in TGS's office. He placed his order with his Toronto broker by telephone from New York to Canada, employing a channel of interstate and foreign commerce. The transaction was consummated on the Midwest Stock Exchange in Chicago. He had previously purchased TGS stock, and on two occasions his orders were executed on the New York Stock Exchange. Though he placed his orders with a Toronto broker, all his purchases were effected on an American stock exchange. Clayton's telephone call from New York on April 15 brought about the purchase. Therefore, the court has subject matter jurisdiction. (Section 27 of the Act, (5488) 15 U.S.C. 78aa; *Ferraiola* v. *Cantor*, CCH FED. SEC. L. REP. ¶91,704 (S.D.N.Y. 1966)). Under Sec-

tion 27 Clayton could be served wherever he was found and service outside of the United States has been sustained. *Ferraiola* v. *Cantor, supra; S.E.C.* v. *VTR Inc.*, CCH FED. SEC. L. REP. ¶91,618 (S.D.N.Y. 1966); *S.E.C.* v. *Briggs*, 234 F. Supp. 618 (N.D. Ohio 1964); see Advisory Committee's Note to the 1963 revision of Rule 4 of Fed. R. Civ. P. reprinted at 31 F.R.D. 627, 630 (1962). Service upon Clayton by leaving the summons and complaint with his wife at his home in Timmins was valid. (Rule 4(d)(1), (e), (f), Fed. R. Civ. P.)

DAVID M. CRAWFORD

Crawford is a lawyer who came with TGS on February 20, 1964, on which date he was appointed secretary of the Company and manager of its public and Government relations. He had not been informed as to the developments on the Kidd 55 segment. He read the rumor article in the *New York Herald Tribune* on April 11 while on his way to Houston to prepare for TGS's annual stockholders' meeting. He returned to New York either late on the 14th or early on the 15th of April, and on that day participated with Fogarty (5489) and a representative of Doremus & Co. in the preparation of the April 16 press release. The evidence establishes that by the evening of April 15 he was fully familiar with the contents of the announcement which was to be made the following morning. He spent the night in a room maintained by TGS at the Drake Hotel in New York City. About midnight he telephoned his broker in Chicago and ordered 300 shares of TGS for himself and his wife to be purchased as soon as the market opened the following day. During the night he decided to increase his order, and he telephoned his broker again at about 8:30 a.m. on April 16 to increase the order from 300 shares to 600 shares. The purchase was

executed on the Midwest Stock Exchange on April 16 at 30⅛ to 30¼.

Here again, while there is no evidence that Crawford intended to deceive or to defraud anyone, it is clear that he sought to, and did, "beat the news." There is no doubt that he believed that he could get the stock more cheaply if he bought before TGS's announcement was made. In so doing, he was utilizing material undisclosed information to his own advantage and violated Section 10(b) and Rule 10b-5. (5490)

(3) *10:00 a.m. April 16 to Close of Business on that Day*

Between the announcement and the close of business on April 16 defendants Coates and Lamont either purchased shares of TGS or recommended their purchase to others.

A regular meeting of the Board of Directors was held at TGS's offices at 9:00 a.m. on April 16. During the meeting defendant Stephens distributed copies of the announcement to be made to the press at the press conference called for 10:00 a.m. Stephens also told the Board that a statement regarding TGS's discovery had been issued in Toronto at 11:00 p.m. the previous evening by the Ontario Minister of Mines. At the conclusion of the Directors' meeting, representatives of the news media, over 22 in all, came into the Board Room. The announcement was made by Stephens, and they were given copies of the press release which Stephens, Fogarty and Crawford had prepared. The press release stated in part:

> "Texas Gulf Sulphur Company has made a major strike of zinc, copper and silver in the Timmins area of Ontario, Canada.

• • • • •

"Seven drill holes are now essentially complete and indicate an ore body of at least 800 feet in length, 300 feet in width and (5491) having a vertical depth of more than 800 feet.

* * * * *

"This is a major discovery. The preliminary data indicate a reserve of more than 25 million tons of ore. The only hole assayed so far represents over 600 feet of ore, indicating a true ore thickness of nearly 400 feet.

* * * * *

"Visual examination of cores from the other holes indicate comparable grade and continuity of ore.

"The ore body is shallow, having only some 20 feet of overburden. This means that it can easily be mined initially by the open pit method."

* * * * *

Summaries of the announcement were carried over the internal news wire of Merrill Lynch, Pierce, Fenner & Smith at 10:29 a.m., and over the Dow Jones broad tape between 10:54 a.m. and 11:02 a.m.

Francis G. Coates

Coates was a Houston lawyer and a member of the Board of Directors of TGS. After reading the *Herald Tribune* article of April 11 he telephoned defendant Stephens from Houston and was told by Stephens that TGS did not have (5492) enough information to know what it had. Coates

came to New York on April 15 and saw a draft of the proposed April 16 announcement that afternoon. On the 16th he attended the Directors' meeting and remained for the press conference at which the announcement was made. The press conference started at 10:00 a.m. and lasted ten or fifteen minutes. Shortly before 10:20 a.m. Coates left the meeting room and telephoned his son-in-law, Haemisegger, a broker in Houston. He told Haemisegger of TGS's discovery and ordered 2,000 shares of TGS stock for the accounts of four family trusts of which he was a trustee but not a beneficiary. Haemisegger executed the order at prices from 31 to 31⅝ on the New York and Midwest Exchanges. Haemisegger immediately imparted the information he had received from Coates to four of his customers, and they, as well as Haemisegger himself, purchased a total of 1500 shares of TGS stock at prices ranging from 31¼ to 35.

Coates lost no time in telephoning his son-in-law in order to purchase TGS stock for his family trusts. Coates could not, as could Lamont when he telephoned Hinton at the Morgan Guaranty Trust Company just before 10:40 a.m. assume "without thinking about it, that the [ore discovery] (5493) was already a matter of public information. . . ." *Cady, Roberts, supra,* at 917. The announcement had been made, however, and it has been the generally accepted rule that it is the making of the announcement that controls. For example, the Commission in *Cady Roberts* found violations of Section 10(b) and Rule 10b-5 for purchases made "during the time when respondents should have known that the board of directors . . . was taking steps to make the information publicly available but *before it was actually announced.*" *Cady, Roberts, supra,* at 915. (Emphasis supplied.) Coates, an experienced corporate lawyer, testi-

fied that he believed that the standard in the marketplace was that once the announcement is made, insiders were free to purchase stock or to recommend it to others.

It may be, as the Commission contends, that a more effective rule should be established to preclude insiders from acting on information after it has been announced but before it has been absorbed by the public. Perhaps such a rule should extend not only to corporate insiders but to others who may be in a position to take unfair advantage of the stockholders. What of a representative of the news media who, upon hearing the announcement, calls his broker before he calls (5494) his office? What of a wire house which has an inside track in getting the information to its registered representatives and to its customers? (The April 16 announcement went out over Merrill Lynch's news wire to its 145 offices half an hour before it went out over the Dow Jones ticker.) Should the representatives of the news media and the wire houses be subjected to such a rule since they are in possession of material information which the average stockholder has not had an opportunity to absorb? These examples are offered merely to illustrate the problems that arise if the present practice is to be changed.

The Commission took the position, on summation, that it is for the courts to fix a reasonable waiting period after an announcement is made, during which insiders cannot purchase stock, so that the announcement can first be absorbed by the public. In other words, it seems to be the Commission's position that a fairer practice than now exists should be evolved through court decisions. This could only lead to uncertainty. A decision in one case would not control another case with different facts. No insider would know whether he had waited long enough after an announcement had been made. He would be subject to suit by the Com-

mission (and to private (5495) suits brought by others riding on the Commission's coattails).

The Commission has not supplied, nor has the Court found, decisions specifying a waiting period after a corporate announcement is made. After this action was instituted, Cary, the former chairman of the Commission, and Fleischer, his former executive assistant, discussed a waiting period in policy terms.[12] If a waiting period is to be fixed, this could be most appropriately done by the Commission, which was established by Congress with broad rule-making powers. Should the Commission determine that it lacks authority to fix a waiting period, authority should come from Congress rather than from the courts.

Since TGS's announcement had been made when Coates telephoned Haemisegger, he did not violate Section 10(b) or Rule 10b-5.

THOMAS S. LAMONT

Lamont was a director of TGS. He was also a director of Morgan Guaranty Trust Company and a member of its Executive Committee and its Trust and Investment Committee. (5496) Lamont testified that he first heard of the exploration on the Kidd 55 segment on April 10 when defendant Stephens telephoned him about the rumors in Canada, and Lamont advised Stephens to ignore them unless they reached the New York press. Stephens informed Lamont that the exploration was "at the prospect stage."

Thereafter, Lamont heard rumors from friends and read the article which appeared in the *Herald Tribune* on April 11, and TGS's April 12 press release as reported in the press. On April 13 or 14 he had a conversation about the rumors with Hinton, the Executive Vice President of Mor-

gan Guaranty Trust Company. Lamont told Hinton that he knew nothing more than had appeared in the press. On April 15 Lamont was informed by Stephens that a press conference would follow the regular Directors' meeting scheduled for the morning of the 16th. Lamont attended the Directors' meeting and read the press release, and attended the press conference at which the announcement was made.

Following the announcement, and while he was still at the TGS office, Lamont telephoned Hinton about 10:40 a.m. and told Hinton that good news about TGS had come out or would be shortly coming out on "the tape." Immediately (5497) following Lamont's telephone call, Hinton telephoned his trading department and was informed that TGS stock was active and up three points. Hinton thereupon placed an order for 2,000 shares of TGS for the account of the Bank's customer, the Nassau Hospital, which order was executed at about 10:41 a.m. Thereafter, Hinton placed further orders for purchases of TGS stock for customers of the Bank, including pension trusts, purchasing a total of 10,000 shares at prices ranging from 32⅝ to 34. At about 12:30 p.m. on April 16 Lamont ordered the purchase of some 3,000 shares of TGS for himself and members of his family, which orders were executed at a price of 34½.

Lamont's telephone call to Hinton was made some 20 minutes after Coates telephoned his son-in-law, both calls being made after the announcement. His own purchases were ordered more than two hours after the announcement.

For the reasons previously stated with respect to defendant Coates, Lamont did not violate Section 10(b) or Rule 10b-5, since the announcement had been made.[13]

(5498) ***Stock Options issued by TGS to certain defendants on February 20, 1964.***

Five of the defendants—Stephens, Fogarty, Kline, Mollison and Holyk—are charged with violating Section 10(b) and Rule 10b-5 by accepting stock options voted to them on February 20, 1964 by the Directors' Committee to Administer the Restricted Stock Option Incentive Plan (the Committee).[14] The Commission contends that these defendants violated the statute and the rule because they had knowledge as to the drilling results of the first hole, K-55-1, which knowledge they failed to disclose to the Committee or to the Board of Directors prior to accepting their options.

TGS's restricted Stock Option Incentive Plan (the Plan) was inaugurated in 1961 with the approval of its stockholders.[15] Three non-management directors, John H. Hill, Leslie M. Cassidy and defendant Coates, were the members of the Committee appointed by the Board. At the meeting of the Committee held on February 20, 1964, two members, Hill and defendant Coates, were present. The minutes disclose that the Board of Directors at its meeting on March 16, 1961 had directed that no shares should be (5499) optioned to any employee earning less than $24,000 annually. The Committee granted stock options to 21 officers and employees earning $24,000 or more per annum (including defendants Stephens, Fogarty, Mollison and Kline) and recommended to the Board the granting of stock options to five employees (including defendant Holyk) whose annual salaries were in the $15,000 to $21,000 range, which recommendation was approved by the Board at its meeting later on the same day.

The use of stock option plans is a commonly accepted device to provide incentive to officers and employees. Restricted stock options of the type authorized by the stock-

holders of TGS are not uncommon in publicly-owned companies. As pointed out by Judge Weinfeld in *Kornfeld* v. *Eaton*, 217 F. Supp. 671, 677 (S.D.N.Y. 1963), *aff'd* 327 F. 2d 263 (2d Cir. 1964):

> " . . . Restricted stock options of the type here under consideration have their genesis in express approval by the stockholders of the corporation and are intended to enable its employees to benefit from an increase in the market value of the security. The corporate purpose is satisfied through the optionee's services and his efforts to further its interests. Indeed it is in the corporate economic interest that its employees have an investment stake in it. Congress itself has recognized the salutary purpose of such plans by extending them favorable tax treatment."

(5500) The Committee necessarily relied on information furnished it by the higher echelon of TGS's management (which would include defendants Stephens and Fogarty, but not Mollison, Kline or Holyk). The Committee did not inquire of the recipients what special knowledge they might have as to various phases of TGS's business as it was entitled to rely on the information furnished by the management.

The record shows that at the time they accepted their stock options, each of the five defendants (except Kline) knew of the situation on the Kidd 55 segment as it existed at the time. Since the land acquisition program had not been completed they had been instructed not to divulge this information. Indeed, on February 20, 1964, neither the Board of Directors nor the Committee had been informed.[16]

Defendant Kline was informed by defendants Stephens and Fogarty at lunch in November 1963 that TGS was con-

ducting explorations in the Timmins area and that the completion of the first drill hole was a favorable development; that it was on the boundary of the TGS property and that TGS was interested in acquiring additional property. He knew no details and his only information came from his (5501) superiors. Defendants Mollison and Holyk knew the results of K-55-1 and had reported these results to their superior, defendant Fogarty. Kline, Mollison and Holyk had no duty to inform the Committee of information already known to their superiors since they could assume that such information would be reported to the Committee by the management.

Defendants Stephens and Fogarty as President and Executive Vice President were management. Both were also Directors and potential recipients of stock options. They were under a duty to inform the Committee of material information affecting the issuance of the stock options. The Plan required that the option price be at least 95% of the fair market value of the stock on the date on which the options are to be granted. The Committee fixed the option price as "the average of the highest and lowest prices of the Company's stock on the New York Stock Exchange during February 20, 1964." Therefore, included in Stephens' and Fogarty's duty of disclosure was any material information bearing on the market value of TGS stock on that date.

A corporate officer may be guilty of fraud if he withholds material information from his company to his own advantage. *New Park Mining Co.* v. *Cranmer,* 225 F. Supp. 261 (S.D.N.Y. 1963). Therefore, if the information known (5502) to defendants Stephens and Fogarty would have substantially affected the price of the TGS stock on the New York Stock Exchange, their receipt of stock options

without disclosure to the Committee could have constituted a fraud on TGS. A stock option is a security (the Act, Section 3(a)(10); 15 U.S.C. 78c(a)(10)), so that such a fraud would have come within the ambit of Section 10(b) and Rule 10b-5. See *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2d Cir. 1964).

On February 20, 1964, defendants Stephens and Fogarty knew (1) that K-55-1 had been completed; (2) that the drill core had been assayed and that the assay certificates showed substantial mineralization; and (3) that the land acquisition program was in progress and that further drilling would await its completion. However, the Court has already determined that the information as to developments on the Kidd 55 segment were not material until 7:00 p.m. on April 9, some seven weeks later. The same definition of materiality applies. Since the information was not material, defendants Stephens and Fogarty were not required to disclose it to the Committee. Hence, defendants Stephens and Fogarty were not guilty of fraud or deception in failing to furnish the information. In (5503) view of the land acquisition program, the security measures which they established were for the benefit of the Company and its stockholders.[17]

In accepting the stock options granted to them on February 20, 1964, defendants Stephens, Fogarty, Kline, Mollison and Holyk did not violate Section 10(b) or Rule 10b-5.

The April 12, 1964 Press Release

On Sunday, April 12, 1964, at about 3:00 p.m., TGS issued a press release, the substance of which appeared in the Monday morning newspapers. The text of the release stated in part:

"NEW YORK, April 12—The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:

" 'During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.

" 'The facts are as follows. TGS has been exploring in the Timmins area for six (5504) years as part of its overall search in Canada and elsewhere for various minerals—lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.

" 'Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.

" 'Recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

" 'The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project.' "

* * * * *

(5506) The Commission argues that at the time the press release was issued, TGS knew that it had discovered a copper mine on the Kidd 55 segment and that the press release was materially misleading in characterizing this discovery as a "prospect" and in stating that "any statement as to size and grade of ore would be premature." For these reasons the Commission contends that the press release violated Section 10(b) and Rule 10b-5.

TGS denies that the press release was false or misleading. Moreover, TGS contends that no violation of Section 10(b) or Rule 10b-5 is made out by the Commission since the press release was not issued "in connection with the purchase or sale of any security." However, the issuance of a false and misleading press release may constitute a violation of Section 10(b) and Rule 10b-5 if its purpose is to affect the market price of a company's stock to the advantage of the company or its insiders. *Freed* v. *Szabo*

Food Serv., Inc., CCH FED. SEC. L. REP. ¶91,317 (N.D. Ill. 1964). The phrase "in connection with the purchase or sale of any security" has been broadly construed "to carry out the intent of the Act, which is designed to protect investors against fraud." *Stockwell* v. *Reynolds & Co.*, (5507) CCH FED. SEC. L. REP. ¶91,579 at 95,198 (S.D.N.Y. 1965); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964).

During the first week of April, rumors of a copper discovery by TGS on the Kidd 55 segment were circulating in Canada. These rumors intensified, and on April 9 Toronto newspapers reported that TGS had discovered "one of the largest copper deposits in North America," "a major copper strike." On April 10, defendant Stephens telephoned defendant Lamont seeking his advice as to what action TGS should take with respect to the rumors. Lamont advised that TGS should take no action unless the rumors reached the New York press or until TGS had sufficient information available to issue an appropriate press release.

On Saturday morning, April 11, 1964, defendant Stephens, while at his home in Greenwich, Connecticut, read the articles appearing in the *New York Times* and the *New York Herald Tribune*. The *Herald Tribune* article announced that TGS had "the biggest ore strike since gold was discovered more than 60 years ago in Canada . . . a bed of copper sulphide 600 feet wide with a possible overall copper return of 2.87% through most of its width."; (5508) that TGS had four drill rigs in operation with four more to go into operation the following week; and that the richness of the copper was so great that it had been flown out of Canada to be assayed.

Stephens telephoned defendant Fogarty at the latter's home in Rye, New York and told him about the articles. Fogarty read the articles and called Stephens back. Fogar-

ty testified that he and Stephens "were quite upset . . . because certainly they [the articles] were full of exaggerations and what I considered to be erroneous statements." Stephens advised Fogarty that TGS should issue a press release to clarify the rumors, referring to his April 10 conversation with defendant Lamont. Stephens asked Fogarty to contact Carroll of Doremus & Co., the Company's public relations firm, who also lived in Rye. Fogarty did so, and Carroll agreed that TGS should issue a press release.

At about 1:00 p.m. on Saturday afternoon, April 11, Fogarty telephoned defendant Mollison at his home in Greenwich, Connecticut, and asked for a review of the situation at the Kidd 55 segment. At about 5:00 p.m. he went to Mollison's home to discuss the matter further. Mollison had been on (5509) the Kidd 55 segment on the morning of April 10 and had been advised by defendant Holyk as to the drilling results to 7:00 p.m. on April 10. At that time drill holes K-55-1, K-55-3 and K-55-4 had been completed; drilling of K-55-5 had started on Section 2200 S and had been drilled to 97 feet, encountering mineralization on the last 42 feet; and drilling of K-55-6 had been started on Section 2400 S and had been drilled to 569 feet, encountering mineralization over the last 127 feet.

In reporting the situation on the Kidd 55 segment, Mollison told Fogarty that the only known mineral occurrences in the area had been at Kamkotia and that these consisted of a series of small disconnected sulphide masses. Mollison advised that it was too early to state what TGS had and "it was impossible at that time . . . to understand the structure, to make the projections from one hole to another." Fogarty went home and drafted notes for a press release which he took to Carroll's house so that they could be put in shape by Carroll for release on Sunday, the following day. He had telephoned defendant Hunting-

ton, one of TGS's lawyers, reading his notes to him. Huntington made one or two suggestions and advised Fogarty that he thought the release would be all right legally.

(5510) On Sunday morning, April 12, Fogarty telephoned Mollison to see if he had any additional information, and instructed Mollison to return with Holyk to Timmins as soon as possible to "move things along." Fogarty and Carroll then completed the final draft of the press release at Carroll's house. Fogarty telephoned Stephens and read the final draft to him, Stephens asking certain questions and making minor changes. Stephens instructed Fogarty to have the release issued as promptly as possible so that it would be on the wires on Sunday afternoon.

From the foregoing, it is apparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment. There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage. The issuance of the release produced no unusual market action. In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or (5511) Rule 10b-5 since it was not issued "in connection with the purchase or sale of any security."

However, even if it had been established that the April 12 release was issued in connection with the purchase or sale of any security, the Commission has failed to demonstrate that it was false, misleading or deceptive. The significance of the drilling results known to TGS by 7:00 p.m. on April 10 was the subject of detailed and conflicting tes-

timony at the trial. Adelstein defined proven ore and probable ore. His definitions were substantially the same as the definitions used in the General Rules and Regulations under the Securities Act of 1933, Appendix I, Form 1-A, Notification Under Regulation A, Schedule I, Item 8A(c), which provide:

> "The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore."

Based on these definitions and the drilling done to 7:00 p.m. on April 10, Adelstein was of the opinion that TGS could have calculated 8.33 million tons of proven ore. Pennebaker, (5512) the other Commission expert, was of the opinion that TGS could have calculated 6.2 million tons of proven ore. Both of the Commission experts stressed that the drilling showed substantial mineralization in the cores and substantial copper miner lization on the eastern edge of the anomaly. Since they could make estimates as to the size and grade of ore on the basis of information to 7:00 p.m. on April 10, the Commission contends that the use of the word "prospect" in the April 12 press release was misleading. Adelstein defined a "prospect" as a property where there is no assurance that commercially mineable reserves exist.

The opinions of Adelstein and Pennebaker were contradicted by Forrester, Park, Wiles, Walkey, Lacy and McLaughlin, independent experts called by TGS (see footnote (9)).

(5513) TGS's experts were unanimously of the opinion that at 7:00 p.m. on April 10 the Kidd 55 segment was still a prospect and that no estimates as to proven or probable ore could be made. They all agreed that the April 12 press release accurately set forth the situation as it was known at the time. None thought that TGS could have estimated proven ore, and the Commission's expert, Pennebaker, agreed that this was a matter on which there could be differences of opinion. Defendants' experts testified that on the basis of the drilling to that time there was no assurance of continuity in the mineralized zone and that, without further drilling, the results of one hole could not be correlated with the results of others.

The Commission contends none the less that the press release was misleading and deceptive because the defendants who prepared the release believed that TGS had a mine. The Commission points to the fact that drilling of K-55-8, the mill test hole, was commenced on April 11, and must have been ordered by the defendants at an earlier time. Both Adelstein and Pennebaker testified that a company does not drill a mill test hole on a "prospect."

(5514) Park, Lacy and Forrester found nothing unusual in this procedure, and Wiles testified that it was usual to begin collecting metallurgical samples as the drilling progresses. With a direct conflict in testimony between the Commission's and defendants' expert witnesses, it cannot be concluded that instructions to drill K-55-8 established that TGS knew that the Kidd 55 segment was no longer a "prospect."

The Commission also points to the *Northern Miner* article which was drafted in Timmins on April 13. Even if it is assumed that Mollison, Holyk and Darke suggested the contents of that article to Ackerley, this would not establish that the April 12 press release was false or deceptive. Using

the Commission's figures, over 30% of the relevant drilling was done between 7:00 p.m. on April 10 and 7:00 a.m. on April 13. K-55-5 was drilled an additional 507 feet; K-55-6 was drilled an additional 375 feet; drilling of K-55-7 was commenced on April 12 on Section 2000 S and was drilled to a length of 146 feet by 7:00 a.m. on April 13. The defendants are to be judged on the facts known to them when the April 12 press release was issued. Mollison and Holyk were not at the site but were in or near New York (5515) while the release was being prepared. There is no evidence that the drilling results after 7:00 p.m. on April 10 were known to the framers of the April 12 press release, so there is no more reason for charging TGS with this knowledge than with knowledge of the statement drafted by Mollison for the Ontario Minister of Mines on April 15, or with knowledge of the information that was available to TGS when it made its announcement on April 16.

Moreover, the circumstances under which the April 12 release was prepared indicate that defendants Fogarty and Mollison were under considerable pressure. If they said too much, they would have been open to criticism and possible liability if it turned out that TGS had not discovered a commercial mine. If they said too little and later announced a mine, they subjected themselves to the charge that their press release was misleading or deceptive—and, indeed, this is what has happened. If they had announced the drilling results in terms of number of drill holes, footage drilled and mineralization intersected, they would have encouraged the rumor mill which they were seeking to allay. Perhaps they should have waited until they could have obtained more probative information before issuing a press release, particularly (5516) since developments were breaking so rapidly. However, as above stated, TGS must not be judged by hindsight. In seeking the advice of Mollison, the

head of TGS's exploration group, in consulting with TGS's public relations firm, and in clearing the release with one of TGS's lawyers, Stephens and Fogarty exercised reasonable business judgment under the circumstances. While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known.[18]

Accordingly, in issuing the April 12 press release TGS did not violate Section 10(b) or Rule 10b-5.

Conclusion

The foregoing constitutes the Court's findings of fact and conclusions of law (Rule 52(a), Fed. R. Civ. P.).

There appearing no just reason for delay, the Clerk is directed to enter judgment dismissing the complaint against defendants Texas Gulf Sulphur Company, Charles F. Fogarty, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Thomas S. Lamont, Francis G. Coates, Claude O. Stephens, John A. Murray, Earl L. Huntington and Harold B. Kline (Rule 58(1), Fed. R. Civ. P.).

(5517) Defendants Richard H. Clayton and David M. Crawford are found to have violated Section 10(b) of the Act and Rule 10b-5. In accordance with the agreement between the parties, the Commission may notice a hearing to determine the remedy to be accorded with respect to these two defendants.

It is so ordered.

Dated: New York, N. Y.
August 16, 1966.

Dudley B. Bonsal
U. S. D. J.

Filed August 19, 1966

(5518) Footnotes to Opinion in Securities and Exchange Commission v. Texas Gulf Sulphur Company, et al. 65 Civ. 1182

(1) At least 49 private actions are now pending in this court against TGS, defendants named in the Commission's action, and others, arising out of the transactions which are the subject matter of the Commission's action. Some 16 of these are individual actions, 31 are said to be class actions, and one is a derivative action. At least 475 persons are included as plaintiffs. While many of the complaints do not specify the damages claimed, others, in the aggregate, claim compensatory damages in excess of $2,800,000 and punitive damages in excess of $77,000,000.

(2) Certain minerals combine with sulphur to form sulphides. Some sulphides, such as chalcopyrite (copper sulphide) and sphalerite (zinc sulphide), may be commercially mined if found in sufficient quantities; others, such as pyrite and pyrrhotite (iron sulphides), have no commercial value.

(3) The electromagnetic instruments used in the aerial geophysicial surveys indicate only that a conductor of electricity exists. There are many good conductors besides sulphides. For example, graphite and even water are good conductors. On the other hand, zinc sulphides are not conductors.

(4) Prior to April 7 a shortage of water needed for drilling prevented the operation of more than one drill rig. The second rig was put into operation on April 8, and the third and fourth rigs were put into operation on April 10 and 12 respectively.

(5) Seven feet of snow on the ground during this period impeded travel between the Kidd 55 segment and Timmins, 15 miles away, the trip taking as long as four hours.

(6) Rule 10b-5 is general in terms. Other rules under Section 10(b) are more specific. See Rule 10b-6, which applies Section 10(b) to underwriters, issuers, brokers, dealers, etc. Compare also Rule 10b-2 with reference to solicitation of purchases on an exchange to facilitate a distribution of securities.

(5519) (7) In its briefs and at trial the Commission made no distinction between the three sections of Rule 10b-5, rely-

ing on *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2d Cir. 1965), where the court noted that as long as a violation of the Rule is alleged, it makes little difference which section of the Rule is invoked. There was no evidence, however, that the defendants employed "any device, scheme, or artifice to defraud" under section (1) or made any representations under section (2). Therefore, only section (3) is applicable to the facts of this case.

(8) Section 206 provides in part that:

> "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; . . ."

(9) At the trial, the Commission called as expert witnesses Benjamin Adelstein and Edwin M. Pennebaker. Mr. Adelstein has been the Chief Mining Engineer for the Commission since 1941. He was previously employed by Anaconda Copper Company and by the United States Coast and Geodetic Survey and the United States Corps of Engineers. Mr. Pennebaker is a mining geologist from Scottsdale, Arizona with many years of experience, who was appointed Consulting Geologist to the Commission in November 1965.

TGS called as expert witnesses: James D. Forrester, geologist, Dean of the University of Arizona School of Mines and Director of the Arizona Bureau of Mines, Tucson, Arizona; Charles F. Park, Jr., geologist, Professor of Geology at Stanford University, where he was Dean of the School of Earth Sciences from 1950-1965; Cloyd M. Wiles, mining engineer with National Lead Company from 1942 until his retirement in 1963; Graham Walkey, mining engineer and geologist with Kamkotia Mines, which is located approximately 12 miles from the Kidd 55 segment; Willard C. Lacy, geologist, professor at the University of Arizona and head of the University's Department of Mining and Engineering; Donald McLaughlin, geologist, Chairman of the Board and formerly president of Homestake Mining

Company; John B. Boniwell, geophysicist with eight years' experience on the Canadian Shield; Douglas H. Bellemore, security analyst, Professor of Finance at the Graduate School of Business (5520) Administration at New York University; and Alvin W. Pearson, security analyst, president of Lehman Corporation and chairman of its Portfolio Committee.

(10) Adelstein testified that on the basis of work done to 7:00 p.m. on April 9 TGS could have calculated ore reserves of 7.7 million tons with a gross assay value of $204,200,000. Pennebaker testified that TGS could have calculated ore reserves of 5.5 million tons with a gross assay value of $197,200,000. Adelstein defined gross assay value to mean "the sum of the products of the number of units of each metal of commercial value times the prevailing price for each metal . . ." Since gross assay value does not take account of the costs of mining, milling, smelting, sales, overhead, cost of capital, etc., it can be misleading and its use in registration statements is prohibited by the Commission. For example, Wiles estimated that 95.2% of the gross assay value of the ore deposit on the Kidd 55 segment would be expended for the above purposes. Although his figures appear to be conservative and though ore with a much lower gross assay value than that on the Kidd 55 segment is commercially mined, his testimony illustrates why gross assay value is not a good indicator.

(11) Members of the TGS exploration group could not state with certainty that K-55-1 had not been drilled down dip. In a memorandum written on November 14, 1963, defendant Holyk stated that:

> "While there are some indications that the drill hole is drilling across the dip, there are also numerous instances of bedding and minerals stratification to be almost parallel to the core axis. Accordingly, it is impossible to estimate the true width of the sulphide zone until a second drill hole is directed across this intersection from west to east. It may well be that the zone is quite narrow in the event that the drill hole has been directed down dip."

The Commission offered testimony as to banding, mineral stratification within the drill core, to establish that K-55-1 had been drilled across the mineral zone and not down dip. The significance of banding, particularly without more drilling, was strongly disputed by defendants' experts.

(5520) (12) In a symposium held on November 22, 1965, former Commission Chairman Cary stated:

> "Directly related is the question when insiders can trade. Again, I doubt whether we can supply a definitive answer. In general, the answer may be: not prior to the time the news has been absorbed by the market. The President of the New York Stock Exchange has suggested thirty days, beginning one week after the distribution of a comprehensive annual report . . . This line, I think, is strict; it goes beyond law, and is really a policy doctrine that he has enunciated. It goes beyond what a lawyer might advise." (Symposium, "Insider Trading in Stocks, *The Business Lawyer,* Vol. XXI, 1009, 1014-1015 (1966).)

Fleischer has written:

> "As a general principle, an insider might be held to violate rule 10b-5 whenever he trades before the effect of the news in question has been absorbed by the market.
>
> * * * * *
>
> "As a matter of corporate practice, it would be advisable for any insider to forego any trading for, say, an arbitrary twenty-four hour period after important news is released to the public." (Fleischer, "Securities Trading and Corporate Information Practices: The Implications of the *Texas Gulf Sulphur Proceeding,*" 51 *Va. L. Rev.* 1271, 1291 (1965).)

(13) Since no violations of Section 10(b) or Rule 10b-5 have been found as to those defendants who recommended TGS stock to others, it is not necessary to consider whether an insider who violates the Statute or the Rule may be liable for purchases made by his "tippees."

(14) The stock options accepted by these defendants were as follows:

Stephens	for	12,800	shares
Fogarty	"	7,300	"
Kline	"	4,300	"
Mollison	"	4,300	"
Holyk	"	2,000	"

Stock options were granted to 21 other officers and employees at the same time, and the total number of shares covered by stock options granted on February 20, 1964 was 89,950.

(5521) (15) The Plan provided that the options would run for ten years from the date of issue, subject to automatic termination in the event of the death or termination of employment of the recipient. At its meeting, the Committee recommended that the plan be amended to reduce the option period from ten years to five years, to become effective on passage of pending Congressional legislation to that effect; that such amendment apply to the options granted on February 20, 1964; and further, that the options issued on February 20, 1964 could not be exercised while any previous qualified or restricted option was held by the optionee. The options provided that the optionees could exercise up to 40% at any time after 18 months, 70% at any time after three years and 100% at any time after four years.

(16) The Board was not informed until its meeting on April 16, 1964, when the Directors were given copies of the press release which was issued following the meeting.

(17) After the Commission instituted this action, the Board of Directors, on July 15, 1965, ratified the issuance of the stock options to Kline, Mollison and Holyk. Stephens and Fogarty surrendered to TGS the options which they received, and these options have been cancelled.

(18) That the drilling results to 7:00 p.m. on April 9 have been held to be material information does not lead to the conclusion that the Kidd 55 segment was either a mine or a prospect twenty-four hours later. It means only that insiders could not use this material information to their own advantage prior to its disclosure to the public.

APPENDIX C

Judgment of the Court of Appeals

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of August, one thousand nine hundred and sixty-eight.

Present:

HON. J. EDWARD LUMBARD, Chief Judge,
HON. STERRY R. WATERMAN,
HON. LEONARD P. MOORE,
HON. HENRY J. FRIENDLY,
HON. J. JOSEPH SMITH,
HON. IRVING R. KAUFMAN,
HON. PAUL R. HAYS,
HON. ROBERT P. ANDERSON,
HON. WILFRED FEINBERG,

Circuit Judges.

Securities and Exchange Commission,
Plaintiff-Appellant,

v.

Texas Gulf Sulphur Co, et al.,
Defendants-Appellees,
David M. Crawford and Richard H. Clayton,
Defendants-Appellants.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order and judgment of said District Court be and they hereby are affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings below consistent with the opinion of this court.

A. DANIEL FUSARO
Clerk

By VINCENT A. CARLIN
Chief Deputy Clerk

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SUPREME COURT, U. S.

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JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1968

Docket No. 937

HAROLD B. KLINE,
Petitioner,

against

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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January 13, 1969

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IN THE

Supreme Court of the United States

October Term, 1968

Docket No. .....

HAROLD B. KLINE,

Petitioner,

against

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable Earl Warren, Chief Justice of the United States, and the Honorable Associate Justices of the Supreme Court of the United States:

Your petitioner, Harold B. Kline, prays that a writ of certiorari issue to the United States Court of Appeals for the Second Circuit for a review of the judgment entered against petitioner, among others, in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Company et al.*, on August 13, 1968. The action has been remanded to the trial court for further proceedings except as to petitioner and Francis G. Coates, who are applying for writs of certiorari.

Opinions Below

The opinion and judgment of the United States District Court, Southern District of New York (Bonsal, J.), in favor of petitioner is reported at 258 F. Supp. 262 and at page 1a, Appendix A. The opinion of Judge Waterman for the Second Circuit Court of Appeals *en banc,* concurred in, in whole or in part, by six other judges of that court, reversing the judgment of the District Court and remanding the case for further proceedings, and the dissenting opinion of Judge Moore, concurred in by Chief Judge Lumbard, are reported at 401 F.2d 833, 870 and pages 67a and 129a, Appendix A.

Jurisdiction

The judgment of the Court of Appeals was entered on August 13, 1968 (172a). A timely petition for rehearing was denied on October 15, 1968, Chief Judge Lumbard and Judge Moore dissenting as to petitioner.

The statutory provision conferring jurisdiction on this Court is found at 62 Stat. 928, 28 U.S.C. §1254(1).

Questions Presented

1. Whether information should be deemed "material" within the meaning of the Securities Exchange Act of 1934 if it "may" affect the desire of "speculators and chartists of Wall and Bay Streets" to buy, sell or hold corporate stock and "might" have an effect on the price of the stock, even though it would not be significant to the average prudent investor and would not have a substantial impact on the market price?

2. Whether a corporate official can be held to possess "material" inside information when he knew no details of a preliminary development within the corporation and there was no evidence that the fragmentary information which he possessed would be significant even to a speculator?

3. Whether it was error for the Court of Appeals to reject findings of the District Court, based on the "virtually uncontradicted testimony" of expert witnesses, as to the insignificance to an average prudent investor of a single exploratory drill hole to a company with 10,000,000 outstanding shares of stock, and to substitute its own findings as to the results of that single hole?

4. Whether Section 10(b) and Rule 10b-5 impose a duty upon a recipient of stock options, granted without inducement on his part, to relate to a corporate Board of Directors, without its request or expectation, any favorable development known to him concerning the corporation, even though such development would not have a substantial market impact or have been significant to an average prudent investor or the Board of Directors?

5. Whether Rule 10b-5, as construed by the Securities and Exchange Commission and the Court below, gave "fair warning" to petitioner, as required by the Fifth Amendment to the United States Constitution and basic principles of administrative procedure, that his conduct would he held unlawful?

6. Whether the Court of Appeals erred in not giving effect to the ratification of the options granted to petitioner by a fully-informed and disinterested Board of Directors?

7. Whether the Court of Appeals erred in directing rescission of petitioner's stock options, contrary to the order of the District Court and the stipulation of the parties that the question of remedy be deferred for further hearing before the District Court, and without giving petitioner an opportunity to be heard regarding such relief?

Constitutional Provisions, Statutes and Rules Involved

Constitution of the United States, Amendment V, is set forth at page 174a of Appendix B to this petition.

48 Stat. 891, 900; 15 U.S.C. §§78j(b), 78u(e) are set forth at pages 174a-175a of Appendix B to this petition.

17 C.F.R. §§240.10b-5 and 240.12b-2(j) are set forth at pages 175a-176a of Appendix B to this petition.

Statement of the Case

A. The Charge Against Petitioner

Respondent filed its complaint in the United States District Court for the Southern District of New York on April 19, 1965, charging petitioner and thirteen others with violations of Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. §78] (the "1934 Act") and of Rule 10b-5 promulgated thereunder. Respondent sought an injunction under Section 21(e) of the 1934 Act and additional relief. Jurisdiction of the District Court was invoked under Section 27 of the 1934 Act (48 Stat. 902, 15 U.S.C. §78aa).

The charges arise from a mineral exploration program begun by Texas Gulf Sulphur Company ("Texas Gulf") in Canada in 1957. In the course of that program an ex-

ploratory hole was drilled near Timmins, Ontario in November of 1963 in an area denominated Kidd 55. Respondent claimed that eleven of the individual defendants "having knowledge and information of material facts concerning the result of * * * Texas Gulf's drilling * * * which facts were not generally known to the investing public" either purchased shares of Texas Gulf stock or recommended their purchase to others. No such charge was made against petitioner, nor was he charged with participation in the issuance of an allegedly misleading press release regarding the progress of drilling by Texas Gulf on April 12, 1964.

The only charge against petitioner was that he was among a group of corporate employees who, on February 20, 1964, "were granted by defendant Texas Gulf's directors options to purchase Texas Gulf stock at a price of $23 13/16 per share" (R. 2871).* It was alleged (and admitted) that when the options were granted the non-management directors who administered the stock option plan and who voted to grant the options were not aware of the results of the exploratory hole. On the basis of these bare allegations, respondent sought to enjoin petitioner "from employing any device, scheme or artifice to defraud, and from engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of securities," and also sought an order directing rescission of the options granted, and return of all profits resulting from their exercise. It was not charged that

* References in this form are to the record filed with this Court by petitioner Francis G. Coates, Docket No. 897. References in the form (a) are to excerpts from that record which are printed as Appendix C to this petition.

petitioner was himself aware of the drilling results or that he had concealed the results from the Board.

Prior to trial, the parties stipulated and the District Court ordered that questions as to remedy would be reserved for later hearing after resolution of the issues concerning liability (1a, 64a).

B. The Facts

The evidence concerning petitioner was uncontradicted and is set forth *in toto* on pp. 190-198a, Appendix C. Following his graduation from law school in 1935 until he joined Texas Gulf in 1958, petitioner practiced law in various capacities (190a). He performed administrative duties for Texas Gulf until 1961 when he was named Secretary of the Company, in which capacity he served until February 20, 1964 (190-91a). He was not engaged in any mineral exploration activities.

At a luncheon in November, 1963 with the President and Executive Vice-President of Texas Gulf, petitioner first heard that the Company was exploring in the Timmins area: "the conversation turned to a favorable development connected with the hole at Timmins, Ontario, and there was a reference to a telephone call which had communicated the word of the favorable development'"* (196a). Asked by respondent's counsel whether he had known in February of 1964 that "a promising single drill hole had been drilled in the Timmins area," he answered:

> "Well I knew that there had been a drill hole which had intercepted a sulphide body,** and I inquired at

* This call took place before the first drill hole was even completed (R. 4819).

** Sulphide bodies are not necessarily valuable and most of them are worthless (R. 495).

> the time, in the case of the November conversation, whether the sulphide mineralization was similar to that at Baffin Island or similar to that at New Brunswick. Those were other areas with which I was familiar." (196a)

He was advised that the mineralization was similar in composition to that at New Brunswick rather than Baffin Island (196a). Neither of these projects—one a copper-zinc sulphide body, the other a lead-zinc sulphide body—have ever been mined (R. 743); and the New Brunswick ore body was classified as "marginal". Texas Gulf geologist Clayton described the New Brunswick deposit as follows:

> "It just sits there. It's an ore body that you think you might be able to mine, but obviously you think you couldn't quite make a profit on it or the profit that you could make on it doesn't quite justify the risk." (R. 746)

The only other reference to the Timmins drilling during the conversation was "that the drilling had been done right on the boundary of such property as we [Texas Gulf] had and that we would be interested in acquiring more property so that further exploration could be conducted" (197a). The problem of land acquisition was not referred to him (197a) and he heard no more about the project until after February 20, 1964 (196a).

Thus, the sum total of petitioner's knowledge about Timmins was that preliminary drilling had encountered mineralization similar to that at New Brunswick and that, although New Brunswick had turned out to be a purely marginal proposition, this was a favorable enough beginning to warrant additional investigation.

On the initiative of the Stock Option Committee, petitioner and 25 other officers and employees of Texas Gulf were granted, on February 20, 1964, options to purchase Texas Gulf stock at its current market price, pursuant to a plan adopted with shareholder approval several years previously (R. 4792). Francis G. Coates, Chairman of the Stock Option Committee, had recommended to the Board that options be granted at that time because the price of Texas Gulf stock had risen to the level at which options had been granted in 1961 and because of certain proposed changes in the tax laws (180a-81a; 184a-85a). The number of shares allotted to each employee was determined by a formula based on salary, and options were granted in consideration of the past and contemplated future services of the employees in order to increase their sense of proprietorship (179a-80a; 184a-87a).

The non-management members of the Board, including the Stock Option Committee, had not, at this time, been informed of the results of the one drill core in Timmins. Although this was in part because of security measures established by Texas Gulf's President in order to facilitate acquisition of the surrounding land,* it was not customary in Texas Gulf, or indeed in any mining company, for directors to be informed of merely preliminary drilling results (188a-89a). The Chairman of the Committee testified that if he had known of the drilling results at the time of the grant of the options, this would not have influenced his decision (189a).

* The District Court found (and respondent stipulated) that "following the usual practice in the mining industry, security measures were put into effect * * * and members of the exploration group were instructed to keep the results of K-55-1 confidential" (8a), and found further that these security measures "were for the benefit of the Company and its stockholders" (49a).

Petitioner, who was not a member of the Board or of the Stock Option Committee, had no role in the determination to grant options but merely recorded the proceedings as Secretary (192a). The only management recommendations relating to possible recipients of the options came from Mr. Stephens and Dr. Fogarty, the chief executive officers (179a). Neither petitioner nor any of the other potential recipients were interviewed by the Stock Option Committee or the Board before the options were voted (189a-90a). It did not cross petitioner's mind to mention his fragmentary knowledge regarding the November drill hole on February 20 (198a).*

On July 15, 1965, more than a year after full disclosure to the Board, to the stockholders of Texas Gulf, and to the public of all drilling results and the subsequent discovery of a mine, and three months after respondent had filed its complaint herein, the Board of Directors, by unanimous vote, determined and declared that the stock options granted to petitioner and others on February 20, 1964, "have been beneficial" to Texas Gulf "and will continue to further the growth and development of the Company, to retain in its employ persons of training, experience and ability, to encourage the sense of proprietorship of such persons and to stimulate their active interest in the development and financial success of the Company" (178a).

Petitioner has not exercised the options granted him, and has continued as Vice-President and General Counsel of Texas Gulf, performing the services for which his options were intended to be part of his compensation.

---

* Indeed, there was no showing that petitioner was aware that the non-management directors or members of the Stock Option Committee had not been informed of the drilling.

C. Opinions Below

1. Materiality of Basic Facts

Most of the testimony at the four week non-jury trial dealt with the exploratory drilling, including the geology of the area, geophysical data in the form of electromagnetic surveys, detailed geologists' logs of the drill hole, assay reports, examinations of the core itself, and the significance of the drilling results to the value of Texas Gulf stock. In addition to Texas Gulf personnel, nine geologists, geophysicists or mining engineers and two security analysts testified. Numerous technical exhibits and several demonstrative charts were considered by the trial judge.

The District Court concluded that "there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body" (29a) and that therefore the results of the first drill core (being the total information which had been accumulated by Texas Gulf geologists when options were granted to petitioner) "were too 'remote' when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares [10,000,000], to have had any significant impact on the market, *i.e.*, to be deemed material" (30a). Thus the District Court held that no disclosure of the initial drilling was required of any defendant, including those who, unlike petitioner, had detailed knowledge of the results.

The Court of Appeals, as the dissenting judges noted, substituted its own geological conclusions, stating that the initial drill core indicated a "more than marginal" possibility of the existence of a mine of "vast magnitude" (89a). It asserted that "material" facts are any "which

may affect the desire of investors to buy, sell or hold the company's securities" (88a), and defined "investors" to include "the speculators and chartists of Wall and Bay Streets" (87a). The Court concluded that the results of the first drill hole, if disclosed, "may" have affected the desires of such persons, and "might" have affected stock prices and, therefore, that the statute and rule prohibited all stock transactions by informed persons, including the acceptance of stock options by "top management" (including petitioner), during the period the results were kept confidential.

2. *Petitioner's Knowledge of the Timmins Exploration*

Based on the uncontradicted testimony, the District Court, which had full opportunity to observe petitioner and evaluate his credibility, found that he had been informed "that TGS was conducting exploration in the Timmins area and that the completion of the first drill hole was a favorable development; that it was on the boundary of the TGS property and that TGS was interested in acquiring additional property. *He knew no details* * * *" (47a-48a; emphasis supplied). And further:

> "The record shows that at the time they accepted their stock options, each of the five defendants (*except Kline*) knew of the situation on the Kidd 55 segment as it existed at the time." (47a; emphasis supplied.)

The Court of Appeals conceded that a violation of Rule 10b-5 could not be found unless individuals engaging in stock transactions had been "apprised of the drilling results" (93a). Yet, although apparently accepting the finding of basic fact that petitioner "knew no details" of the situation at Kidd 55, the Court of Appeals neverthe-

less held that the vague, general information imparted to him while at lunch in November constituted knowledge of "material facts." The dissenting judges found that "it seems clear that [petitioner] did not possess material information" (146a).

3. *Petitioner's Duty of Disclosure*

Again, based on uncontradicted evidence, the District Court found as follows:

> "The [Stock Option] Committee necessarily relied on information furnished it by the higher echelon of TGS's management (which would include defendants Stephens and Fogarty, but not Mollison, Kline or Holyk). The Committee did not inquire of the recipients what special knowledge they might have as to various phases of TGS's business as it was entitled to rely on the information furnished by the management." * * *
>
> "[Petitioner] knew no details and his only information came from his superiors. Defendants Mollison and Holyk knew the results of K-55-1 and had reported these results to their superior, defendant Fogarty. Kline, Mollison and Holyk had no duty to inform the Committee of information already known to their superiors since they could assume that such information would be reported to the Committee by the management." (47a-48a)

The Court of Appeals rejected the trial court's delineation of petitioner's duties and its findings (based on the testimony of members of the Option Committee) as to the persons upon whom the Committee relied, and asserted its belief that petitioner was under a duty of disclosure because of his ministerial duties as Secretary and as the recently appointed General Counsel (103a).

4. *Ratification*

The effect of the ratification of petitioner's options was not reached by the District Court. The Court of Appeals indicated approval of ratification in a footnote:

> "* * * where disclosure to the grantors of an option would seriously jeopardize a corporate security, it could well be desirable * * * not to require that an insider possessed of undisclosed material information reject the offer of a stock option, but only to require that he abstain from exercising it until such time as there shall have been a full disclosure and after the full disclosure, a ratification such as was voted here." (103a, n. 24)

Despite this language, the Court, without explanation, declared that the ratification of petitioner's options was "irrelevant" and ordered that they be cancelled.

5. *Rescission*

The District Court did not discuss remedy, it being expressly ordered that this issue would be reserved "for later hearing * * * in the event * * * violations are found" (1a). After noting the stipulation and order and stating that the question of relief "is not now before us" (69a, n. 1), and without granting petitioner any hearing on the question of relief, the Court of Appeals nevertheless held:

> "as [petitioner] did not disclose such information to the Option Committee we direct rescission of the option he received." (103a)

The relief, if any, to be directed against the other individuals was referred to the trial court on remand.

Reasons for Allowance of the Writ

1. The Court of Appeals has decided questions of federal substantive law under the securities laws, which are of great importance and wide application to corporate personnel and the public generally. In particular the Court of Appeals has created tests of "materiality" in the context of the 1934 Act which are unworkable, have created widespread confusion in the business community and which conflict with the SEC's own long-standing regulations and with standards adopted by the Seventh and Tenth Circuits and by the Second Circuit itself in previous decisions.

2. The Court of Appeals has imposed unprecedented and highly uncertain duties on corporate employees and others who deal with securities. This application of Section 10(b) and Rule 10b-5 raises serious questions of due process and lack of fairness in the administrative procedures followed by the SEC.

3. The Court of Appeals has departed from the accepted and usual course of judicial proceeding by overturning and ignoring findings of fact of the District Court contrary to Rule 52(a) of the Federal Rules of Civil Procedure, and by ignoring the stipulation of the parties and the order of the District Court reserving the question of appropriate relief for a further hearing before that court, thereby depriving petitioner of a hearing on that question.

4. The Court of Appeals has, in conflict with a decision of the Ninth Circuit, ordered ancillary relief which goes beyond statutory authority and the exercise of federal equity powers as defined by this Court.

ARGUMENT

I

The definition of materiality in the context of Rule 10b-5 is an important question of federal substantive law which should be settled by this Court. The Court of Appeals adopted a standard of materiality in conflict with regulations adopted by the Securities and Exchange Commission, decisions of the Seventh and Tenth Circuits and its own previous decisions. Moreover, the Court of Appeals disregarded Federal Rule of Civil Procedure 52(a) in overriding the District Court's findings of fact as to the materiality of the preliminary drilling and petitioner's knowledge thereof.

The concept of materiality is fundamental to federal securities regulation. The Securities Act of 1933 (15 U.S.C. §77a) and the Securities Exchange Act of 1934 require accurate disclosure of material facts in all documents filed pursuant to those acts, and those who misrepresent or conceal material facts in violation of those statutes are subject to heavy penalties and liabilities.

Because of the importance of this concept, the SEC has taken great care in drafting rules defining "materiality" under each of the major acts it administers.* All these definitions limit material facts to "those matters as to which an average prudent investor ought reasonably to be informed." In the present case, this traditional test of materiality has been abandoned both by the SEC and

* See, *e.g.*, Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)) under the Securities Exchange Act of 1934; Rule 210.1-02(g) (17 C.F.R. §210.1-02(g)) of Regulation S-X which governs all financial statements filed under the securities laws; Rule 405 (17 C.F.R. §230.405 (1)) of Regulation C under the 1933 Securities Act; and Rule 8b-2 (17 C.F.R. §270.8b-2) under the Investment Company Act of 1940 (15 U.S.C. §80a-1).

the Court of Appeals and replaced with a standard under which a fact can be deemed material merely because it "may" affect the desires of "speculators and chartists" to buy, sell or hold securities or "might" have an effect on the market price. Obviously, almost any information could fall in such a category, especially with the aid of hindsight.

A. To be material for purposes of Section 10(b) and Rule 10b-5, a fact must be one that would affect the judgment of an average prudent investor.

Section 10(b) of the 1934 Act, which is not self-operative, prohibits only certain conduct which is "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." The rule defining materiality under the 1934 Act provides:

> "The term 'material' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered." Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)).

This standard of the "average prudent investor" was properly applied by the District Court in reaching its decision, but disregarded by the Court of Appeals. The speculators and chartists of Wall and Bay Streets can, by no stretch of the imagination, be deemed to be the "average prudent investor" envisaged by the SEC regulations and these two standards cannot exist side by side.

The standard created by the Court of Appeals also conflicts with earlier judicial elaborations of the "average prudent investor" test. Thus, the Seventh Circuit in *James*

Blackstone Memorial Library Ass'n. v. *Gulf, M. & O. R. R.*, 264 F.2d 445, 450-51 (7th Cir.), *cert. denied*, 361 U.S. 815 (1959) held that only "assured" facts, not mere possibilities, were material. Similarly, in *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied sub nom. List* v. *Lerner*, 382 U.S. 811 (1965), the Second Circuit held that material facts were those "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities * * *." It was this precedent which was applied by the District Court (25a-26a), but distorted by the Court of Appeals.

Again, it was clear that the drilling results as of February 20, 1964, did not indicate the existence of "proven" or "probable" ore under the SEC regulations governing disclosure concerning mining explorations, quoted in the dissenting opinion below (136a-137a). In *Sunray DX Oil Co.* v. *Helmerich & Payne Inc.*, 398 F.2d 447 (10th Cir. 1968), the Tenth Circuit held that equivalent regulations were controlling in determining whether facts concerning oil exploration were "material," requiring disclosure. The instant decision is in conflict with that of the Tenth Circuit, and should be reviewed by this Court.

Finally, it is clear that the Court of Appeals' alternative statement of the test of materiality in terms of market impact was internally inconsistent and totally unworkable. Thus, the Court seemingly first required a showing of a "substantial" or "significant" impact on the market as had the District Court (26a):

> "An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in 'those situations which are essentially

> extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed.' Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding,* 51 Va. L. Rev. 1271, 1289'' (86a).

The Court of Appeals went on, however, to hold that facts are material which ''might'' affect the market, evidently to any extent, and indeed held as to petitioner, in particular, that facts would be material if they ''might affect the price of the stock'' at any time during the five-year period ''when the accepted option could be exercised'' (103a, n. 24). This unworkable and ill-defined application of Rule 10b-5 has created widespread anxiety throughout the corporate and financial communities. See, *e.g.,* Bromberg, *Implications of Texas Gulf Sulphur,* 1 THE REVIEW OF SECURITIES REGULATION 985 (December 2, 1968).

If the standards adopted and applied to petitioner are correct, then no corporation's employees could ever safely buy or sell its stock, or accept stock options, for they could always be charged with having done so while knowing ''material facts'' which had not been disclosed.

Judge Bonsal was clearly right in holding that information ''is not material merely because it would be of interest to the speculator on Bay Street or Wall Street'' (25a). It is hardly probable, or even conceivable, that the Congress, in outlawing ''manipulative or deceptive devices,'' intended that prospective recipients of stock options should be required to make certain that the Board of Directors or Stock Option Committee were aware of any and all facts

about their company that "*might*" affect the market price of the optioned stock or which a speculator "*may*" consider of interest. Merely to state the proposition proposed by the SEC and sanctioned by the Court of Appeals is to demonstrate its absurdity.

B. There is no evidence that petitioner's knowledge meets any of the standards of materiality which were articulated by the Court of Appeals.

Even if the tests of materiality as variously articulated by the Court of Appeals were to be sustained, there is no evidence of record to sustain the finding of violation against petitioner. The District Court's finding that he "knew no details" was not questioned by the Court of Appeals. There is no evidence that what petitioner knew, if disclosed, "might" have had any effect on the market price of Texas Gulf stock at any time or "may" have affected a speculator's investment desires. To use the Court of Appeals' own delineation of the "material facts," there was no evidence that petitioner was informed, in his casual luncheon conversation, that: (1) the possibility of finding a mine was "more than marginal"; (2) any mine which might exist would be "of vast magnitude"; (3) the drill core was "remarkably rich"; (4) the drill core indicated that the mine would be "rather close to the surface" or that this, in turn, suggested "mineability by the less expensive open-pit method"; (5) the drill core was "within the confines of a large anomaly"; and (6) a large anomaly suggested "an extensive region of mineralization" (88a-89a). Again, in reaching its conclusion that the detailed results of the first hole "might well have affected the price of TGS * * *," the Court of Ap-

peals relied heavily on one witness who was impressed by the length of "a 600 foot drill core" (90a). Petitioner, however, knew nothing about the length of the core.

In contrast to such details, the Court of Appeals found only that petitioner had known since November "that the drilling had intersected a sulphide body containing copper and zinc [which was equally true of the marginal ore body in New Brunswick], and that TGS desired to acquire adjacent property [for further exploration]" (103a). There is no testimony, expert or otherwise, from which a court could conclude that this information "might" have affected the market or "may" have interested a speculator. Moreover, there is no analysis in the Court of Appeals' opinion of how the fragmentary and general information known to petitioner satisfied its tests of "material information." The finding against petitioner is without evidentiary support and must be reversed. *Thompson* v. *Louisville,* 362 U. S. 199 (1960).

C. The Court of Appeals disregarded Rule 52(a).

The Court of Appeals reached its conclusion that the results of the first hole constituted "material information" by ignoring or overturning findings of fact of the trial judge, based on his appraisal of the testimony of eleven expert witnesses, and his study of numerous exhibits and charts containing geological and geophysical data. The District Court credited expert testimony to the effect that "one drill core does not establish an ore body, much less a mine" and, indeed, that "there is no way even to estimate the probabilities that one drill core will lead to the dis-

covery of an ore body" and that "no predictions could be made as to how far mineral values encountered by [the first drill core] extended beyond the 1⅛ inch drill core," and that "from an investment point of view, no significance could be attached to the results of a single drill hole" (30a). The District Court also found that disclosure of the preliminary drilling results would not have had a substantial impact on the market price of Texas Gulf's 10,000,000 outstanding shares (30a).

The majority of the Court of Appeals did not give the findings of the District Court the consideration and weight required by law. As pointed out by the dissenters, the majority, in disregard of FED. R. CIV. P. 52(a), chose "to reject the trial court's finding as to the results of the first drill core, K-55-1, and to substitute their own expertise in the mining engineering field * * *" (135a). Thus, the majority stated that from the first hole there was a "possibility which surely was more than marginal of the existence of a mine of * * * vast magnitude * * *" (89a), an interpretation of the geological and geophysical data directly at odds with that of the District Judge and the "virtually uncontradicted testimony" of the experts (135a). Indeed, the Court below never referred to the distinguished experts called by defendants and credited by the District Judge, but heavily relied on the deposition testimony of one Michael Roche, a Canadian penny stock speculator, to support its geological and investment conclusions (90a). The procedures followed below conflict with basic principles of appellate jurisdiction repeatedly stated by this Court (see, *e.g.*, *Graver Tank & Mfg. Co. Inc.* v. *Linde Air Prods. Co.*, 339 U. S. 605, 609-10 (1950)) and should be corrected.

II

The Court of Appeals has created an undefined and unrealistic standard of disclosure of which the statute and rule gave no warning.

A. The duty imposed by the Second Circuit bears no relation to fraud or deceit prohibited by Rule 10b-5.

Rule 10b-5 forbids conduct which operates as a "fraud or deceit" in connection with the purchase and sale of securities. There is, however, no sense in which concepts of "fraud or deceit" could conceivably apply to the conduct of petitioner *vis-a-vis* the Board of Directors of Texas Gulf; missing entirely are three basic elements of fraud—a misrepresentation or breach of a duty to disclose; purposeful deception (*scienter*); and, as demonstrated above, knowledge of material facts.

There is no evidence that petitioner fraudulently induced the Board to grant him options or actively concealed any information from the Board. Indeed, there is no evidence that petitioner knew that either the Option Committee or the Board was unaware of the November drilling on February 20, 1964. The Court of Appeals stated that the "essence" of Rule 10b-5 is that a person knowing material inside information may not take "advantage of such information *knowing it is unavailable to those with whom he is dealing*" (85a; emphasis supplied), citing respondent's own statement of Rule 10b-5 in *Matter of Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). Since petitioner did not know of such unavailability, he could not have violated Rule 10b-5. Cf. RESTATEMENT OF TORTS, §551, comment *a*

(1938). Nor was petitioner "dealing" with the Board of Directors, or taking any "advantage" of his knowledge.

Moreover, the Chairman of the Option Committee testified that his decision to grant options would not have been influenced by the drilling results (189a). The Seventh Circuit has held, in an action brought under Rule 10b-5, that "[insiders] are not required to search out details that presumably would not influence the person's judgment with whom they are dealing." *Kohler* v. *Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963).

The Court of Appeals completely disregarded the question of *scienter* with respect to petitioner. Thus, there was no evidence that petitioner knew "material facts"; that he knew or should have known that the Board or Option Committee did not know such facts; or that he knew or should have known that silence would be deceptive. Respondent's proof as to petitioner did not, therefore, fulfill the requirements of knowledge and purposefulness set forth in *S.E.C.* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 192 n. 39 (1963).

The Court of Appeals, by finding against petitioner on a record which showed no misrepresentation or duty of disclosure, no *scienter*, and no knowledge of material facts, has thus totally departed from the language of Rule 10b-5 and has created an impossible and unascertainable standard of conduct.

B. The decision of the Court of Appeals violates petitioner's constitutional rights under the Fifth Amendment and violates principles of administrative procedure.

An administrative body must state its rules so "that the ordinary person can know in advance how to avoid an unlawful course of action." *M. Kraus & Bros. Inc.* v. *United States*, 327 U. S. 614, 622 (1946). See *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337 (1952). Rule 10b-5 certainly gave no warning to petitioner that he had a duty to inform the Board of Directors of a general conversation referring to preliminary indications of a favorable development before accepting stock options granted to him.

Rather than promulgate a rule which would operate prospectively, after allowing for public comment as required by the Administrative Procedure Act, the Commission has instead persuaded the Court of Appeals, in this case of first impression, to interpret petitioner's conduct as the employment of a "manipulative or deceptive device or contrivance," and therefore a violation of Rule 10b-5. The Court, however, made no effort to analyze how petitioner's conduct came within any expressed or reasonably inferable prohibition of the statute or rule. It is important that this Court consider the statutory and constitutional limitations upon respondent's powers and the grossly unfair procedures whereby the statute and rule have been extended, without regard to proper legislative and administrative procedures, far beyond their language and purpose. Compare *Blau* v. *Lehman*, 368 U. S. 403 (1962).

III

Failure to give effect to the ratification of petitioner's options frustrates the fully informed choice of the granting corporation.

The failure of the Court of Appeals, while approving of ratification in principle, to give effect to the ratification of petitioner's unexercised options frustrates the corporate interest and is an unwarranted interference with the exercise of business judgment by the Company's directors. Congress has expressly recognized the salutary purposes served by stock options, stating: "it is good for the economy for management of various businesses to have a stake in their successful operation. * * * This is not only good for the specific business involved, but also for the economy as a whole." H.R. Rep. No. 749, 88th Cong., 1st Sess. 64 (1963). The Court of Appeals gave no reason or authority for its refusal to honor the ratification of petitioner's options, in the corporate interest, by a fully informed, disinterested and unanimous Board of Directors.

IV

The Court of Appeals' order of rescission, disregarding the order of the District Court that there be a hearing on remedy in that court, deprived petitioner of his right to be heard. The order directing rescission goes beyond statutory authority and the proper exercise of federal equity power.

The Court of Appeals' action directing relief against petitioner contrary to court order and stipulation will, if uncorrected, deprive petitioner of a hearing on this question before the District Judge, who has had the opportunity of observing and questioning him, and is therefore best able to make an initial determination as to the proper remedy, if any. A finding of liability does not require the issuance of an injunction (*Hecht Co.* v. *Bowles*, 321 U. S. 321 (1944)), much less entry of an order of rescission. Even if the District Court had the power to order rescission, it should be given the opportunity to determine its necessity in the light of the facts of petitioner's case, and, if required, whether it should be total or partial. In particular, petitioner should not be denied a hearing as to whether rescission is appropriate in spite of the fact that his options were ratified by a disinterested and fully informed Board of Directors.

As a fundamental matter, however, respondent has been granted power under Section 21(e) of the 1934 Act only to bring actions "to enjoin" violations of the Act. There is no authority in Section 21(e), as there is in some other federal regulatory statutes, permitting the entry of "other

orders." Under a similar statute, the Ninth Circuit held there was no power to order ancillary relief. *United States* v. *Parkinson,* 240 F. 2d 918 (9th Cir. 1956). Accord: *S.E.C.* v. *National Securities, Inc.,* 252 F.Supp. 623 (D. Ariz. 1966), *aff'd* 387 F. 2d 25 (9th Cir. 1967), *cert. granted,* 390 U.S. 1023 (1968), a decision construing Section 21(e).

There are many grounds on which the District Court might properly decline to issue an injunction against petitioner, including, of course, the fact that likelihood of future wrongdoing is non-existent. The injunctive process is designed to deter, not to punish* (*Hecht Co.* v. *Bowles, supra,* 321 U. S. at 329). If, on equitable grounds, the District Court refused to issue an injunction against petitioner, its jurisdiction would then cease, and it would have no power to grant ancillary, punitive relief by way of rescission. See *United States* v. *Moore,* 340 U.S. 616 (1951); Note, 79 HARV. L. REV. 656, 657-58 (1966); Note, 65 MICH. L. REV. 944, 949-50 (1967).

There is no reason or justification in the present circumstances for the judicial creation of an additional remedy to respondent, clearly beyond the powers granted to it by Congress.

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* As Texas Gulf's Board of Directors has specifically found that the grant of options to petitioner was beneficial to the Company, rescission is purely punitive. Section 32 of the 1934 Act provides for criminal penalties, including fines. (15 U.S.C. §78 ff.) The Court of Appeals' order, in effect, exacts a greater fine than authorized by statute, without affording petitioner the safeguards of a criminal proceeding. There is no authority for such a penalty in an action designed for "prophylactic" purposes. *Cf. S.E.C.* v. *Capital Gains Research Bureau, Inc.,* 375 U. S. 180 (1963).

Conclusion

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Dated: New York, N. Y.
January 13, 1969

Respectfully submitted,

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APPENDIX A

Opinion of the District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

65 Civ. 1182

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

against

TEXAS GULF SULPHUR COMPANY, a Texas corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD, THOMAS S. LAMONT, FRANCIS G. COATES, CLAUDE O. STEPHENS, THOMAS P. O'NEILL, JOHN A. MURRAY, EARL L. HUNTINGTON and HAROLD B. KLINE,

Defendants.

(5436) BONSAL, D. J.

Plaintiff, Securities and Exchange Commission (Commission), has instituted this action charging each of the defendants with violations of Section 10(b) of the Securities Exchange Act (15 U.S.C. 78j(b)) and Rule 10b-5 (17 C.F.R. 240; 10b-5) promulgated thereunder by the Commission. All parties waived a jury and agreed that trial should first be had on the issue of whether the defendants or any of them had violated Section 10(b) and Rule 10b-5, reserving for later hearing the issue of the remedy to be applied in the event such violations are found.

The Commission's action arises out of the exploratory activities of defendant Texas Gulf Sulphur Company (TGS) on the Kidd 55 segment near Timmins, Ontario, between November 12, 1963 and April 16, 1964. TGS is (5437) alleged to have violated Section 10(b) and Rule 10b-5 by issuing a false press release regarding these activities on April 12, 1964. Each of the individual defendants was a director, officer or employee of TGS. Individual defendants who purchased stock or calls on stock of TGS between November 12, 1963 and April 16, 1964, or recommended such purchases to others, are charged with violations of Section 10(b) and Rule 10b-5 on the ground that they used to their own advantage material information as to TGS's exploratory activities on the Kidd 55 segment, which material information had not been disclosed to or absorbed by the stockholders or the public. Five of the individual defendants who accepted stock options granted on February 20, 1964 are charged with violations of Section 10(b) and Rule 10b-5 on the ground that they

were in possession of such material information which they used to their own advantage by failing to disclose it to the Directors' Committee which granted the stock options.[1]

TEXAS GULF SULPHUR COMPANY (TGS)

In 1963-64 TGS (which was organized in 1909) was the world's largest supplier of sulphur. Its authorized capital stock was 15,000,000 shares, without par value. (5438) 11,520,000 shares had been issued (including 1,504,101 shares held in the Company's treasury). On December 31, 1963, there were issued and outstanding in the hands of the public in excess of 10,000,000 shares held by some 65,000 shareholders. The stock of TGS was listed on the New York Stock Exchange and was admitted to unlisted trading privileges on the Midwest Stock Exchange. TGS's total assets, less current liabilities, had a book value of over $169,000,000 as of December 31, 1963, and over $210,000,000 as of December 31, 1964. The stockholders' equity was stated to be in excess of $129,000,000 as of December 31, 1963, and in excess of $137,000,000 as of December 31, 1964. Its annual sales were in excess of $62,000,000 for 1963 and in excess of $70,000,000 for 1964. Its working capital was approximately $47,000,000 as of December 31, 1963, and approximately $87,000,000 as of December 31, 1964. Its earnings per share for the period 1960-1964 were:

1960	1961	1962	1963	1964
$1.27	$1.26	$1.21	$0.93	$1.15

From 1955 to 1963 TGS's annual sales declined from $93,000,000 in 1955 to $62,000,000 in 1963 and its (5439) annual earnings from $32,000,000 in 1955 to $9,300,000 in 1963. This decline was attributed by TGS to the oversupply of sulphur, resulting in depressed prices during the period.

The market price of TGS stock on the New York Stock Exchange declined from a high of $45 a share in 1955 to a low of $11 a share in 1962. In 1963 the price rose from 13¾ in March to 19⅜ in November and to 21⅞ at the end of the year. In 1964 the price rose from a low of 21⅛ in January to a high of 30¼ on April 15. On April 16, the day of TGS's public announcement of the Kidd mine, the price rose from a low of 30⅛ to a high of 37, closing at 36⅜. The price continued to rise during the balance of April 1964 to a high of 58⅜ on April 30, on which day the stock closed at 54¾.

Between 1956 and 1963, despite a growth in the demand for sulphur, the price per ton of sulphur declined from around $28 in 1956 to under $20 in 1963. However, by late 1963 the turn-around had been reached. Sulphur became in short supply, and on April 1, 1964 TGS announced a $2 per ton increase in the price. TGS's gross sales for (5440) 1963 were the highest in four years, up 5.56% from 1962.

TGS's 1963 earnings were adversely affected by the mysterious loss of the S.S. Makine Sulphur Queen early in that year. In January 1964 TGS put into service a larger liquid sulphur cargo vessel to replace the lost vessel and announced the launching of the world's largest liquid sulphur tanker, which would make it possible to ship liquid sulphur to Europe, and on February 8, 1964 it announced plans to increase its Canadian production of sulphur by 500 tons per day.

Apart from its primary sulphur business, TGS was engaged in a diversification program in other fields, such as phosphate, potash, trona, oil and gas. Its entry into the phosphate and potash fields was important because phosphate, potash and sulphur are the three basic components of fertilizers. On November 15, 1963, TGS announced the creation of a new division for its phosphate project and that its potash mine was near completion and was scheduled

to go into production in the spring of 1964. On December 16, 1963, TGS announced that it had acquired the Canadian oil and gas properties of Delhi-Taylor Oil Company, and on April 3, 1964 announced plans (5441) to proceed with a 3,000,000 ton-per-year phosphate program in North Carolina at a cost of $45,000,000.

TGS had been engaged in exploration for sulphide deposits on the Canadian Shield since 1957 and in 1963-64 undertook exploratory work on the Kidd 55 segment in Kidd Township near Timmins, Ontario, which is more fully described hereafter.

THE INDIVIDUAL DEFENDANTS

The individual defendants are directors, officers and employees of TGS as follows:

Defendant	Position
Claude O. Stephens	President and Director
Charles F. Fogarty	Executive Vice President* and Director
Thomas S. Lamont	Director
Francis G. Coates	Director
Harold B. Kline	Vice President and General Counsel**
Richard D. Mollison	Vice President
David M. Crawford	Secretary***
Richard H. Clayton	Engineer
Walter Holyk	Chief Geologist
Kenneth H. Darke	Geologist
Earl L. Huntington	Attorney
John A. Murray	Office Manager

* Prior to February 20, 1964 Mr. Fogarty was Senior Vice President.

** Prior to January 31, 1964 Mr. Kline was Vice President-Administration and Secretary.

*** Mr. Crawford was employed by TGS in January 1964 and became Secretary on February 20, 1964.

(5442) Defendant Thomas P. O'Neill was an accountant with TGS. He was served with a summons and complaint, but has failed to answer or appear. The Commission has moved for a default judgment against O'Neill in a separate proceeding. Therefore he is not referred to hereafter.

Summary of TGS's Exploratory Activities on the Kidd 55 Segment

Exploration on the Canadian Shield:

In 1957 TGS initiated an exploration program for sulphides[2] on the Canadian Shield, a vast area comprising most of eastern Canada. Much of the area is barren and flat with few outcroppings of rock and is covered with a swampy material known as muskeg. The subsurface structure consists of Pre-Cambrian rocks, dating from an early geologic time, and is complex and distorted.

(5443) Beginning in March, 1959, an exploration group—headed by defendant Mollison, a mining engineer, and consisting of defendant Holyk, the chief geologist; defendant Clayton, an electrical engineer and geophysicist; and defendant Darke, a geologist—conducted aerial geophysical surveys over more than 15,000 miles of the Canadian Shield area. Sulphides conduct electricity better than most other rock types and can be detected if they are in sufficient quantity and concentration and are not too deeply buried beneath the earth's surface.[3]

In the course of this aerial exploration, TGS detected several thousand anomalies—unusual variations in the conductivity of rocks. In the opinion of the exploration group several hundred of these anomalies were (5444) worthy of further investigation, and rights to land around them were

acquired. One of these anomalies, detected as early as 1959, was located near Timmins, Ontario, and was designated as the Kidd 55 segment. On June 6, 1963, TGS acquired an option to purchase the northeast quarter section (160 acres) of the Kidd 55 segment. Between November 8, 1963 and April 16, 1964 TGS drilled K-55-1, K-55-3, K-55-4, K-55-5, K-55-6, K-55-7 and K-55-10 at the locations shown on the accompanying Plan Map of the Kidd 55 segment.

Drill Hole K-55-1

On October 29 and 30, 1963, defendant Clayton conducted a ground geophysical survey on the northeast quarter section which confirmed the existence of the anomaly previously detected by the aerial survey. Defendant Clayton interpreted the survey as indicating three separate conductors of electricity tending in a north-south direction with an undetermined width and steep dip. Since the survey only indicated the presence of conductive material and not whether the material consisted of worthless or valuable minerals and since there was little geological evidence as to the makeup of the subsurface structure (the (5446) nearest outcroppings of rock were located more than 1,000 feet from the property), diamond core drilling was necessary for

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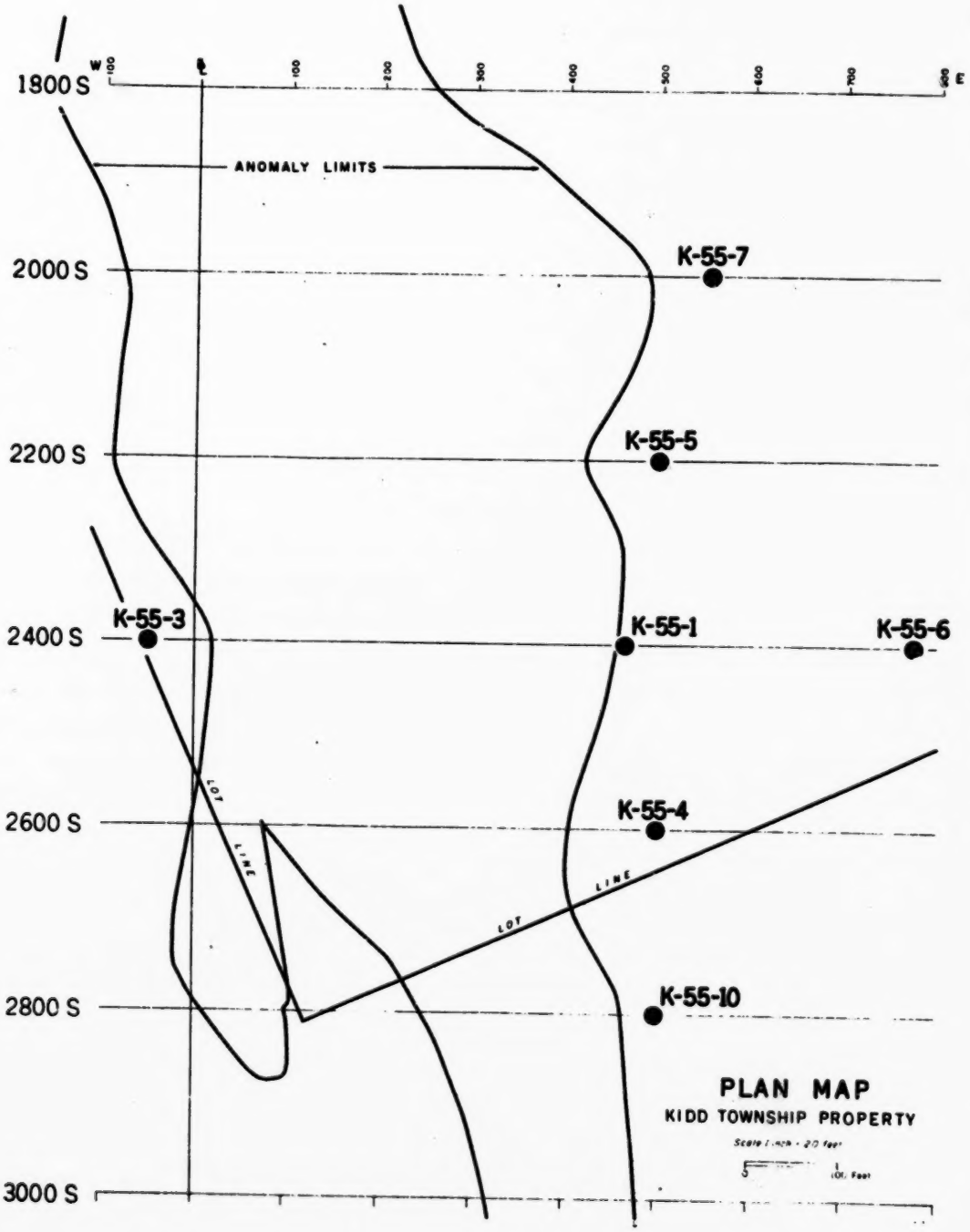
(5445)

Plan Map

KIDD TOWNSHIP PROPERTY

PHOTOPRINT
(Mounted Opposite)


W
100
0
100
200
300
400
500
600
700
800
E
1800 S
ANOMALY LIMITS
2000 S
K-55-7
2200 S
K-55-5
2400 S
K-55-3
K-55-1
K-55-6
2600 S
K-55-4
LOT LINE
LOT LINE
2800 S
K-55-10
3000 S
PLAN MAP
KIDD TOWNSHIP PROPERTY
Scale 1 inch = 20 feet
1
(Ot. Feet

further evaluation of the anomaly. TGS had previously drilled 65 equally promising anomalies, but most of them had revealed either barren pyrite or graphite, while a few had shown marginal mineral deposits in insufficient quantities to be commercially mined.

On November 8, 1963, drilling of the initial hole (K-55-1) was begun on section line 2400 S. The location, direction, and angle of the hole were determined by defendants Holyk, Clayton and Darke, who considered the results of the geophysical survey and the location of property boundaries. The collar of the hole was placed about 60 feet to the east of the easternmost conductor, as interpreted by defendant Clayton, and at the strongest part of the anomaly. The hole was drilled westerly at an angle of 60 degrees in the hope that it would cut through all three conductors.

On November 12, 1963, drilling of K-55-1 was terminated at 655 feet. Defendant Holyk visually estimated that the core of K-55-1 indicated an average copper content of 1.15% and an average zinc content of 8.64% over a length of 599 feet. The percentages of copper and zinc (5447) mineralization at any given point in the core fluctuated markedly, but the copper mineralization appeared to be concentrated more on the eastern edge of the anomaly.

Property Acquisition

As a result of the visual examination of the core, TGS determined to acquire the three other quarter sections making up the Kidd 55 segment. Therefore, following the usual practice in the mining industry, security measures were put into effect. Further drilling on the anomaly was suspended and members of the exploration group were instructed to keep the results of K-55-1 confidential. The drill rig at the site of K-55-1 was moved away and cut sap-

lings were stuck in the ground in the area of the hole to conceal its location. A second drill hole (K-55-2) was drilled off the anomaly in order to produce a barren core.

The core from K-55-1 was split longitudinally and shipped to the Union Assay House, Salt Lake City, Utah, for chemical assay. In mid-December, TGS received reports from the assay which revealed an average metal content of approximately 1.18% copper and 8.26% zinc, as well as 3.94 ounces of silver per ton over a 602-foot length of the core. These were the only chemical assay reports on any drill hole which TGS received prior to April 16, 1964.

(5448) In the meantime, negotiations for the three other quarter sections comprising the Kidd 55 segment had been undertaken. TGS purchased one quarter-section outright for $7,500 and acquired options for $7,000 to purchase the other two for approximately $45,000. On March 27, TGS decided that the land acquisition program had advanced sufficiently to permit the company to resume drilling.

Drill Hole K-55-3

On March 31, the drilling of K-55-3 was commenced on section line 2400 S approximately 75 feet west of the western limits of the anomaly and approximately 510 feet west of K-55-1. It was drilled easterly at an angle of 45 degrees, and therefore crossed K-55-1 in a vertical plane on section 2400 S. K-55-3 was completed by 7:00 p.m. on April 7 and visual estimates of the core indicated an average copper content of 1.12% and an average zinc content of 7.93% over 641 feet of the hole's 876-foot length. Like K-55-1, K-55-3 indicated substantial copper mineralization on the eastern edge of the anomaly. Daily reports of the progress of K-55-3 and of the subsequent drill holes were made by defendants Mollison and Holyk to defendants Stephens and Fogarty.

(5449) *Drill Hole K-55-4*

On April 7, drilling of K-55-4 was commenced slightly to the east of the eastern edge of the anomaly on section line 2600 S, 200 feet to the south of K-55-1, and was drilled westerly on an angle of 45 degrees, parallel to K-55-1. By 7:00 p.m. on April 9, K-55-4 had encountered mineralization over 366 feet of its 420-foot length, but had entered a stretch of barren material at the 420-foot mark. The hole was completed to a length of 579 feet on April 10 at 7:00 p.m. without encountering further mineralization. Visual estimates of the 366 feet of mineralized core recovered from K-55-4 indicated an average copper content of 1.14% and an average zinc content of 8.24%. Like K-55-1 and K-55-3, K-55-4 encountered substantial copper mineralization on the eastern edge of the anomaly.

Drill Holes K-55-6 and K-55-5

On April 8, drilling of K-55-6 was commenced with a second drill rig[4] on section 2400 S, 300 feet to the east of K-55-1. It was drilled westerly at an angle of 60 degrees and was intended to explore mineralization beneath hole K-55-1. Due to the absence of geologists from the drill site on April 8 and 9,[5] no immediate visual estimates of the core were available. It was apparent, (5450) however, by the evening of April 10 that the hole had encountered substantial copper mineralization over the last 127 feet of its 569-foot length.

On April 10, drilling of K-55-5 was commenced with a third drill rig on section 2200 S, 200 feet north of K-55-1. The hole was started on the eastern edge of the anomaly and was drilled westerly at an angle of 45 degrees, parallel to the holes previously drilled. By the evening of April 10, K-55-5 had been drilled 97 feet and, although no immediate visual estimates of the core were available, it was apparent

that the hole had intersected substantial copper mineralization over the last 42 feet of its length.

The results of drilling through the evening of April 10 were available to TGS when it issued its April 12 press release.

Core Drilling between 7:00 p.m. April 10 and 7:00 a.m. April 13

Drilling of K-55-5 and K-55-6 continued, and by the morning of April 13, K-55-5 had encountered mineralization to the 580-foot mark. It was subsequently drilled to a length of 757 feet without encountering further mineralization. Visual estimates of the core indicated that over a 525-foot section the drill hole had intersected an average (5451) copper mineralization of 0.82% and an average zinc mineralization of 4.2%. By 7:00 a.m. on April 13, K-55-6 had encountered mineralization to the 946-foot mark. It was subsequently drilled to a length of 1180 feet without intersecting any further mineralization. Visual estimates of a 504-foot section of the core indicated an average copper content of 1.72% and an average zinc content of 6.60%.

On April 12 drilling of K-55-7 was commenced with a fourth drill rig on section 2000 S at the eastern edge of the anomaly. It was drilled westerly at an angle of 45 degrees and by the morning of April 13 had encountered 50 feet of mineralization over the 137 feet drilled. The drilling of a mill test hole, K-55-8, was also commenced by April 11 and completed by the evening of April 13. The core was 2¼ inches in diameter as compared with the 1⅛ inch diameters of the other holes, and was intended to be used for metallurgical testing to determine the amenability to milling of the material that had been encountered. No geologist's log or visual estimates were made of K-55-8 and no metallurgical tests of the core were reported prior to April 16.

(5452) ***Core Drilling between 7:00 a.m. April 13 and 7:00 p.m. April 15***

On April 14 drilling of K-55-10 was commenced on section 2800 S on the eastern edge of the anomaly and was drilled westerly at an angle of 45 degrees. By 7:00 p.m. on April 15, it had encountered mineralization over the last 231 feet of the 249 feet of drilling. Drilling of K-55-7 was completed to a length of 707 feet, but encountered only 26 more feet of mineralization between the 425-foot and the 451-foot marks.

PURCHASE OF TGS STOCK AND CALLS ON TGS STOCK BY CERTAIN DEFENDANTS AND "TIPPEES" BETWEEN NOVEMBER 12, 1963 AND APRIL 16, 1964

The evidence established that all of the individual defendants except Stephens and Kline purchased shares of TGS and/or calls on TGS stock between November 12,
(5453) 1963, when the first drill hole on the Kidd property was completed (K-55-1), and the close of business on April 16, 1964, the day on which TGS issued a press release announcing the discovery of a copper mine on the Kidd 55 segment at a press conference called for the purpose. The evidence also shows that certain persons who were referred to by counsel at the trial as "tippees" purchased shares of TGS and/or calls on TGS stock on the basis of advice received directly or indirectly from defendants Darke, Coates and Lamont. The following table lists these purchases (including those of defendant Holyk's wife), but does not include the shares covered by stock options granted by TGS to certain defendants on February 20, 1964.

Purchase Date	Purchaser	Shares Number	Shares Price	Calls Number	Calls Exercise Price
HOLE K-55-1 COMPLETED NOVEMBER 12, 1963					
1963					
Nov 12	Fogarty	300	17¾-18		
15	Clayton	200	17¾		
15	Fogarty	700	17⅝-17⅞		
15	Mollison	100	17⅞		
19	Fogarty	500	18⅛		
26	Fogarty	200	17¾		
29	Holyk (Mrs.)	50	18		
CHEMICAL ASSAYS OF DRILL CORE OF K-55-1 RECEIVED DECEMBER 9-13, 1963					
Dec 10	Holyk (Mrs.)	100	20⅜		
12	Holyk (or wife)			200	21
13	Mollison	100	21⅛		
30	Caskey*			300	22¼
30	Fogarty	200	22		
31	Fogarty	100	23¼		
1964					
Jan 6	Holyk (or wife)			100	23⅝
8	Murray			400	23¼
16	Westreich*	2000	21¼-21¾		
24	Holyk (or wife)			200	22¼-22⅜
Feb 10	Fogarty	300	22⅛-22¼		
17	Atkinson*	50	23¼	200	23⅛
17	Westreich*	50	23¼	1000	23¼-23⅝
20	Darke	300	24⅛		
24	Clayton	400	23⅞		
24	Holyk (or wife)			200	24⅛
24	Miller*			200	23¾
25	Miller*			300	23⅜-23½
26	Holyk (or wife)			200	23⅜
26	Huntington	50	23¼		
27	Darke (Moran as nominee)			1000	22⅝-22¾
Mar 2	Holyk (Mrs.)	200	22⅜		
3	Clayton	100	22¼		
3	E. W. Darke*			500	22½-22⅝
16	Huntington			100	22⅜
16	Holyk (or wife)			300	23¼
17	Holyk (Mrs.)	100	23⅜		
17	E. W. Darke*			200	23¾
23	Darke			1000	24¼
26	Clayton	200	25		

Purchase Date	Purchaser	Shares		Calls	
		Number	Price	Number	Exercise Price
LAND ACQUISITION COMPLETED MARCH 27, 1964					
Mar 30	Atkinson*			400	25¾-25⅞
30	Caskey*	100	25⅞	1000	25¾-25⅞
30	Darke			1000	25½
30	E. W. Darke*			200	25½
30	Holyk (Mrs.)	100	25⅞		
30-31	Klotz*			2000	25½-26⅛
30	Miller*			500	25½-25⅞
30	Westreich*	500	25¾		
CORE DRILLING OF KIDD 55 SEGMENT RESUMED MARCH 31, 1964					
Apr 1	Clayton	60	26½		
1	Fogarty	400	26½		
2	Clayton	100	26⅞		
6	Fogarty	400	28⅛-28⅞		
8	Mollison (Mrs.)	100	28⅛		
421 FEET KIDD-55-4 COMPLETED APRIL 9, 1964, 7 P.M.					
TGS PRESS RELEASE ISSUED APRIL 12, 1964					
Apr 15	Clayton	200	29⅜		
16	Crawford (and wife)	600	30⅛-30¼		
TGS PRESS RELEASE AND PRESS CONFERENCE APRIL 16, 1964, 10 A.M.					
Apr 16	Coates (for family trusts)	2,000	31-31⅝		
16	Haemisegger**	300	32½		
16	Robt. L. Armstrong**	200	31¼-34½		
16	Charles Callery**	300	32½		
16	James A. Baker III**	200	32⅝		
16	Malcolm G. Baker Jr.**	500	34½-35		
16	Morgan Guaranty Trust Co.***	10,000	32⅝-34		
16	Lamont and family****	3,000	34½		

* Darke visited Mrs. Caskey and her daughter Miss Atkinson in Washington between Dec. 25 and Dec. 30, 1963 and recommended TGS. They in turn recommended TGS directly or indirectly to others marked with *, with the exception of E. W. Darke, Darke's brother, who purchased calls on Darke's recommendation.

** Purchased by Haemisegger, Coates' son-in-law, for himself and customers (**) following telephone call from Coates before 10:20 a.m.

*** Purchased for its customers' accounts following call from Lamont to Hinton at about 10:40 a.m.

**** Purchased through Morgan Guaranty Trust Co. after 12:33 p.m.

(5456) THE SECURITIES EXCHANGE ACT OF 1934 (THE ACT) AND RULE 10b-5

The Commission has instituted this action pursuant to Section 27 of the Act (15 U.S.C. 78aa) which confers upon the District Courts of the United States exclusive jurisdiction of violations of the Act or of the rules and regulations promulgated thereunder and of "all suits in equity and actions at law brought to enforce any liability or duty created by" the Act or the rules and regulations thereunder.

The preamble of the Act states that it is "to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."

Section 2 (15 U.S.C. 78b) provides that:

> ". . . transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, . . . and to impose requirements necessary to make such regulation and control reasonably complete and effective, (5457) in order to protect interstate commerce . . . and to insure the maintenance of fair and honest markets in such transactions. . . ."

Section 2(2) (15 U.S.C. 78b(2)) provides:

> "The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold. . . ."

Section 2(3) (15 U.S.C. 18b (3)) states that:

> "Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control. . . ."

Section 4(a) (15 U.S.C. 78d(a)) provides for the establishment of the Commission as the agency charged with the administration of the Act.

Section 10 of the Act (15 U.S.C. 78j) provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

(5458) Pursuant to the authority conferred on the Commission by Section 10(b), in May, 1942 the Commission

promulgated Rule 10b-5 (17 C.F.R. 240; 10b-5), which provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

In Rule 10b-5 the Commission adapted the language of Section 17(a) of the Securities Act of 1933 (15 U.S.C. 77q) relating to fraudulent interstate transactions. Similar language was also used in Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6).[6]

The Commission has the responsibility of administering the Act and of securing compliance therewith. To carry out this responsibility, it has been given, among other powers, authority under Sections 21(e) and 27 (15 U.S.C. 78u, 78aa) to institute actions in the district courts to (5459) enjoin existing or prospective violations of the Act and to enforce any liability or duty created by the Act or the rules and regulations promulgated pursuant thereto. The Commission contends that the defendants engaged in a "course of

business" which operated "as a fraud or deceit" on the stockholders of TGS in violation of Section 10(b) and Rule 10b-5.[7]

The defendants assert that the Commission must establish the elements of common law fraud—misrepresentation or nondisclosure, materiality, scienter, intent to deceive, reliance, and causation—citing decisions in private actions brought under Section 10(b) requiring proof of one or more of these traditional elements as a condition precedent to relief. *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783, 786 (2d Cir. 1951) ("proof of fraud is required in suits under §10(b) of the 1934 Act. . . ."); *Weber* v. *C.M.P. Corporation*, 242 F. Supp. 321, 324 (S.D.N.Y. 1965) (scienter); *Barnett* v. *Anaconda Company*, 238 F.Supp. 766, 771 (S.D.N.Y. 1965) (causation). See, Comment, "Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity," 74 *Yale L. J.* 658 (1965).

(5460) However, recent decisions, even in private suits, do not require proof of these elements in actions charging violations of Rule 10b-5. *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210 (9th Cir. 1962); *Ellis* v. *Carter*, 291 F. 2d 270 (9th Cir. 1961). In *Stevens* v. *Vowell*, 343 F. 2d 374, 379 (10th Cir. 1965), the court stated:

> "It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact."

In a regulatory or enforcement proceeding under Section 27 of the Act, the Commission is not required to prove these common law elements. In *S.E.C.* v. *Capital Gains Bureau*, 375 U.S. 180 (1963), the defendant was an invest-

ment advisor who published a monthly report, mailed to approximately 5,000 customers, which recommended certain securities for long term investment. Before mailing the report, the defendant would purchase the recommended securities on the market and when the price rose after customers received the report, defendant would sell at a profit. The Commission sought an injunction under Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6) (8) (5461) to compel defendant to disclose this practice to customers. The district court denied a preliminary injunction on the ground that "fraud" was used in the Investment Advisers Act of 1940 in its technical common law sense and that the Commission had failed to establish an intent to injure clients or an actual loss to clients. (191 F. Supp. 897, 898.) The Second Circuit Court of Appeals, sitting *en banc,* affirmed the district court by a 5-to-4 vote. (306 F. 2d 606.)

In reversing, the Supreme Court held that:

> "It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit,' intended to require proof of intent to injure and actual injury to clients. (375 U.S., at 192.)
>
> • • • • •
>
> "Congress intended the Investment Advisers Act of 1940 to be *construed like other securities legislation* 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes. (375 U.S., at 195.) (Emphasis supplied)

Since there is a direct parallel between the language of Rule 10b-5(3) and Section 206 of the Investment Advisers Act of 1940, both in wording and in intent, the use of "fraud" in Rule 10b-5(3) cannot be interpreted in its narrow common (5462) law sense. *Cf., Berko* v. *Securities and Exchange Commission,* 316 F. 2d 137 (2d Cir. 1963).

The suggestion made by the defendants that Section 16 of the Act (15 U.S.C. 78p), relating to directors, officers, and principal stockholders, defines "insiders" and limits the liabilities of insiders to the sanctions provided in Section 16, is equally without merit. A Section 16 action can be brought only by the corporation itself or derivatively by an existing security holder against officers, directors or beneficial owners of ten per cent or more of the corporation's listed equity securities. It covers only short-swing profits realized within a six-month period, and any recovery inures to the corporation. Profits are recoverable regardless of any intent to defraud and without proof that they were realized by reason of inside information. In short, Section 16 was enacted as a "crude rule of thumb" to make unprofitable all short-swing speculation by a specifically defined group of insiders. See, *Blau* v. *Lamb,* F. 2d (2d Cir., June 27, 1966).

A Section 10(b) action, on the other hand, may be brought pursuant to Section 27 by the Commission or by any party claiming to have been defrauded. The section (5463) applies to "any person," not merely to the persons encompassed by Section 16. *H. L. Green Co.* v. *Childree,* 185 F. Supp. 95 (S.D.N.Y. 1960) (accountants); *Cady, Roberts & Co.,* 40 S.E.C. 907 (1961) (broker). Section 16 requires both a purchase and a sale of a listed security, while Section 10(b) applies to a purchase or sale of any security. The numerous differences between Section 16 and Section

10(b) clearly indicate that the provisions of the former impose no limitation on the enforcement of the latter. See, 3 Loss, *Securities Regulation,* 1473, 1474 (2d ed. 1961); Comment, "The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors," 59 *Yale L. J.* 1120, 1140-42 (1950).

To establish violations of Section 10(b) and Rule 10b-5(3), the Commission must prove that the defendants engaged in a "course of business" which operated as a "fraud or deceit . . . in connection with the purchase or sale of any security." Questions arise therefore as to whether insider purchases based on material, undisclosed information constitute violations of Section 10(b) and Rule 10b-5(3); if so, who are insiders; whether the statute and rule are limited to "face-to-face" transactions; and, finally, what constitutes material information.

(5464) The statute and rule go at least as far as the federal common law rule. *List* v. *Fashion Park, Inc.,* 340 F.2d 457, 461-2 (2d Cir. 1965). As long ago as 1909, the Supreme Court held in *Strong* v. *Rapide,* 213 U.S. 419 (1909), that the failure of the director and general manager of a corporation to disclose "special facts" in purchasing its securities operated as a fraud on the seller. The Court stated that:

> "If it were conceded, for the purpose of the argument, that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company before he purchases any from a shareholder, yet there are cases where, by reason of the special facts, such duty exists." 213 U.S., at 431.

Applying this "special facts" doctrine to Section 10(b) and Rule 10b-5, trading by an insider on the basis of material undisclosed information constitutes a deceptive practice in violation of the statute and rule. See, Loss, *supra*, at 1445-73.

In *Strong* v. *Rapide*, the defendant was a director and general manager of the corporation, and owned three-fourths of its outstanding shares. He was, therefore, an (5465) insider under any standard. Section 10(b) has been construed as imposing a similar liability on officers, directors, and major stockholders. *Cochran* v. *Channing Corporation*, 211 F. Supp. 239 (S.D.N.Y. 1962). Further, since Section 10(b) applies to "any person" it can include "insiders" who are not officers, directors or major stockholders. *Cady, Roberts & Co., supra*, at 912.

In *Brophy* v. *Cities Service Co.*, 70 A. 2d 5, 7 (Del. Ch. 1949), the court pointed out "if an employee in the course of his employment acquires secret information relating to his employer's business, he occupies a position of trust and confidence toward it, analogous in most respects to that of a fiduciary, and must govern his actions accordingly."

Citing *Brophy*, the Commission in *Cady, Roberts & Co., supra*, found that the obligation to disclose material information rests on two grounds:

> ". . . first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing." 40 S.E.C., at 912.

(5466) Therefore, insiders subject to the disclosure requirements of Section 10(b) and Rule 10b-5 may include employees as well as officers, directors, and controlling stockholders who are in possession of material undisclosed information obtained in the course of their employment.

An insider's liability for failure to disclose material information which he uses to his own advantage in the purchase of securities extends to purchases made on national securities exchanges as well as to purchases in "face-to-face" transactions. *List* v. *Fashion Park, Inc., supra,* at 461-62. In *Cochran* v. *Channing Corporation, supra,* at 243, the court stated:

> "The Securities Exchange Act was enacted in part to afford protection to the ordinary purchaser or seller of securities. Fraud may be accomplished by false statements, a failure to correct a misleading impression left by statements already made or, as in the instant case, by not stating anything at all when there is a duty to come forward and speak. It is the use of inside information that gives rise to a violation of Rule 10b-5. [Citations omitted.] Lack of communication between defendant and plaintiff does not eliminate the possibility that Rule 10b-5 has been violated."

And, as noted in *Cady, Roberts,* "it would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, (5467) primary markets for securities transactions." 40 S.E.C., at 914.

In response to the defendants' contention that it would be impossible for an insider trading on a national exchange

to seek out the other party to the transaction and disclose material information to him (*Goodwin* v. *Agassiz*, 186 N.E. 659 (Mass. 1933)), it is clear that there are other ways of disclosing significant corporate developments. The New York Stock Exchange provides in its *Company Manual* that "important developments which might affect security values or influence investment decisions should be promptly disclosed." (Listing Agreement at A-20.) If legitimate business reasons require a period of non-disclosure, the insider should forego transactions in his company's securities during that period. *Cady, Roberts, supra*, at 911. As stated by the court in *Oliver* v. *Oliver*, 45 S.E. 232, 234 (Ga. 1903):

> "It might be that the director was in possession of information which his duty to the company required him to keep secret; and, if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his (5468) own advantage, and to the disadvantage of one whom he also represents. The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known."

However, to establish a violation of Section 10(b) and Rule 10b-5, the undisclosed information must be material. *List* v. *Fashion Park, Inc.*, *supra*. There is nothing in the Act which precludes insiders from purchasing stock of their company or from being beneficiaries of the company's incentive stock option plan. On the contrary, it is important,

under our free enterprise system that insiders, including directors, officers, and employees, be encouraged to own securities of their company. The incentive that comes with stock ownership benefits both the company and its stockholders.

Moreover, it is obvious that any director, officer, or employee will know more about his company or have more specialized knowledge as to at least some phase of its business than an outside stockholder can have or expect to have. Often this specialized knowledge may whet the speculative interest of the insider, particularly if he believes in the future of his company, and may lead him to purchase stock. Purchases under such circumstances are not encompassed by Section 10(b) and Rule 10b-5. As stated (5469) in Loss, *supra*, at 1463:

> ". . . an insider is under no obligation to give the ordinary investor the benefit of his superior financial analysis. It has been aptly said that, 'Even though a shrewd guess by an insider is often worth fifty accounting statements, it would be highly unfair to make him publicize his guess and then to hold him responsible if it turns out to be wrong.' " (Quoting, Comment, "The Prospects for Rule X-10b-5," 59 *Yale L. J.*, at 1148.)

However, where an insider comes into possession of *material* information which he uses to his own advantage by purchasing stock or calls on the stock of his company prior to public disclosure, he violates Section 10(b) and Rule 10b-5. Information is not material merely because it would be of interest to the speculator on Bay Street or Wall Street. Material information has been defined as information "which in reasonable and objective contemplation

might affect the value of the corporation's stock or securities. . . ." *List* v. *Fashion Park, Inc., supra,* at 462, citing, *Kohler* v. *Kohler Co.,* 319 F. 2d 634, 642 (7th Cir. 1963). It is information which, if known, would clearly affect "investment judgment," *Cady, Roberts, supra,* at 911, or which directly bears on the intrinsic value of a company's stock. See, *Kardon* v. *National Gypsum Co.,* 73 F. Supp. 798 (E.D. Pa. 1947); *Speed* v. *Transamerica Corp.,* 99 F. Supp. 808 (5470) (D. Del. 1951); *Ward LaFrance Truck Corp.,* 13 S.E.C. 373 (1943).

Material information need not be limited to information which is translatable into earnings, as suggested by defendants. But the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight. As stated by a former member of the staff of the Commission:

> "It is appropriate that management's duty of disclosure under rule 10b-5 be limited to those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed. A more rigorous standard would impose an unreasonable burden on management in its securities trading. Moreover, such a standard could involve the courts to an unrealistic degree in the determination of whether certain types of information might have an impact on the market. A finer web might well prevent some management trading that represents an abuse, but only at the cost of possibly exposing management to meritless litigation in many other cases." (Fleischer, 'Securities Trading and Corporate Information Practices: The Implications of the *Texas Gulf Sulphur* Proceeding,' 51 *Va. L. Rev.* 1271, 1289 (1965).)

(5471)

APPLICATION OF SECTION 10(b) OF THE ACT AND RULE 10b-5 TO PURCHASES BY INDIVIDUAL DEFENDANTS

All of the individual defendants were directors, officers or employees of TGS. With the exceptions of Stephens and Kline, each purchased stock of TGS using the facilities of a national securities exchange. Accordingly, the jurisdictional requirements of the Act and Rule 10b-5 have been satisfied with respect to these purchases. The issue remains as to whether any of the defendants in purchasing TGS stock or calls on TGS stock were using for their own advantage material information as to the drilling on the Kidd 55 segment not disclosed to the public. Defendants Huntington and Murray had no detailed knowledge as to the work and hence were not in possession of material information. Huntington knew only that TGS was acquiring property rights in Kidd Township. Murray had no knowledge of the situation on the Kidd 55 segment at the time he made his purchases. In considering whether the remaining individual defendants were in possession of material information when they made their purchases, the period from November 12, 1963 to April 16, 1964 may be conveniently subdivided as follows:

(1) November 12, 1963 to 7:00 p.m. April 9, 1964

(2) 7:00 p.m. April 9 to 10:00 a.m. April 16, 1964

(3) April 16, 1964 from 10:00 a.m. to the close of business on that day.

(5472)

(1) *November 12, 1963 to 7:00 p.m. April 9, 1964*

K-55-1 was completed on November 12, 1963. Visual estimates at the drill site, which were subsequently confirmed

by chemical assays received in mid-December, indicated substantial zinc and copper mineralization over approximately 600 feet of the core's 657 foot length. On the basis of the visual estimates, TGS took customary security measures to maintain the secrecy of the drilling results while it undertook to acquire the remaining quarter sections of the Kidd 55 segment. On March 31, 1964 drilling was resumed.

K-55-3 was drilled and established that mineralization existed in a vertical plane over 350 feet wide and 500 feet deep. On April 7 drilling of K-55-4 was begun 200 feet south of K-55-1 and by 7:00 p.m. on April 9 it had been drilled to 421 feet and had encountered 366 feet of mineralization. K-55-1, K-55-3, and K-55-4 intersected substantial copper mineralization on the eastern edge of the anomaly.

According to the Commission's experts, Adelstein[9] (the Commission's chief mining engineer) and Pennebaker (consulting geologist to the Commission), K-55-4 established a third dimension to the mineralized zone, so that the (5473) drilling through 7:00 p.m. on April 9 established a mine.[10]

The geologists called by the defendants disputed the conclusions reached by Adelstein and Pennebaker, unanimously agreeing that the drilling of the three holes to 7:00 p.m. on April 9 did not establish that TGS had a mine. The Commission has taken the position with respect to registration statements filed under the Securities Act of 1933 that "three diamond drill holes are insufficient to determine whether a commercial ore body is present, even though they should encounter a gold bearing structure." *Pan-American Gold Ltd.*, 31 S.E.C. 141, 147-8 (1950).

It is unnecessary to determine whether TGS had a mine since the drilling of K-55-4 to 7:00 p.m. on April 9 was a strong indication that the mineralization encountered on the vertical plane between K-55-1 and K-55-3 extended southward 200 feet. There was real evidence that a body

of commercially mineable ore might exist. At 7:00 p.m. on April 9, those with knowledge of the drilling results had material information which it was reasonably certain, if disclosed, would have had a substantial impact on the market price of TGS stock. Therefore, they were under a duty not to use such material information to their personal advantage without first disclosing it to the public.

(5474) However, the drilling results up to 7:00 p.m. on April 9 did not provide such material information. When considered in relation to the far-flung business of TGS at the time, it cannot be said that the drilling results of K-55-1 and K-55-3 constituted material information, the disclosure of which would have had a substantial impact on the market price of TGS's 10,000,000 outstanding shares.

K-55-1

There is no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it. However, all the experts agreed that one drill core does not establish an ore body, much less a mine. Defendants' experts unanimously concluded that there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body. Concededly, the geophysical survey conducted prior to the drilling of K-55-1 indicated a "first class" anomaly over a length of more than 1,000 feet, but the conductive materials evidenced by the survey outside the first drill hole could have consisted of worthless pyrite or graphite, both of which materials were found in the core of K-55-1. As stated by Boniwell, a mining geophysicist, (5475) geophysics is of little help in predicting continuity.

Moreover, the core of K-55-1 was not solid ore. The percentages of copper and zinc mineralization fluctuated

markedly. Although it appears this is not unusual due to the complex nature of the Pre-Cambrian subsurface rock structure, it supports the testimony of defendants' experts that no predictions could be made as to how far mineral values encountered by K-55-1 extended beyond the 1⅛ inch drill core. As was brought out by Walkey, a mining engineer employed by Kamkotia Mines 12 miles from the Kidd 55 segment, mineral deposits on the Canadian Shield tend to be highly irregular in structure, with wide variations in grade. Walkey, Boniwell and Wiles (a mining engineer with forty years' experience) testified as to instances where one drill hole had produced a promising core but subsequent drilling had shown that the mineral values did not extend any appreciable distance beyond that core. Therefore, the first promising core may turn out to be a liability by inducing further drilling with negative results.[11]

Bellemore and Pearson, security analysts called by defendants, testified that from an investment point of (5476) view no significance could be attached to the results of a single drill hole, however rich.

The most that can be said of the individual defendants' knowledge after the drilling of K-55-1 is that they had "hopes, perhaps with some reason," that it would lead to a mine. *James Blackstone Mem. Lib. Ass'n* v. *Gulf, M. & O. R. Co.*, 264 F. 2d 445, 450 (7th Cir. 1959). The results of K-55-1 were too "remote" when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, *i.e.*, to be deemed material. *List* v. *Fashion Park, Inc., supra.*

The Commission contends, however, that the results of K-55-1 were material because of the significance attached to

those results by certain defendants. Between the completion of K-55-1 on November 12, 1963 and the completion of K-55-3 on April 7, 1964, defendants Fogarty, Mollison, Holyk, Clayton and Darke spent more than $100,000 in purchasing stock and calls on the stock of TGS. These defendants could bring considerable expertise to bear in evaluating the results of K-55-1 and their purchases may have been prompted by an educated guess that K-55-1 would (5477) lead to the discovery of a mine. Therefore, a question is presented as to whether information which may have special significance to an insider because of his professional background, is material.

A similar question would be presented where an engineer in the research department of a publicly-held corporation believes that he may have invented a process which will substantially increase the corporation's earnings or where a chemist in a large pharmaceutical firm thinks that he may have devised a chemical formula which can cure cancer. In these instances it can be assumed that the insider, because of his educated guess, will be enthusiastic and his enthusiasm may lead him to purchase stock in his company and to recommend the stock to his associates and friends even though his educated guess may turn out to be wrong. It may be argued that such purchases are "unfair" to the outside stockholders and come within the ambit of Section 10(b) and Rule 10b-5. Purchases on the basis of educated guesses may be viewed as an attempt to secure additional corporate compensation. Cary, "Corporate Standards and Legal Rules," 50 *Calif. L. Rev.* 408 (1962).

(5478) However, most insiders necessarily have educated guesses about the prospects of particular company programs. If it is held that purchases made on the basis of educated guesses are proscribed by Section 10(b) and Rule

10b-5, insiders who purchase stock in their company will do so at their peril. If they announce their educated guesses before purchasing and their guesses turn out to be wrong, they would be subject to suit; and if they purchase and keep their educated guesses to themselves and they turn out to be right, they would again be subject to suit. The creation of such a dilemma would result in insiders not buying at all although insiders should be encouraged to have a stake in the companies for which they work.

The outside stockholder can never match the knowledge of an insider who necessarily knows more about the company and is in a better position to evaluate its prospects. It may be that the "fairness" overtones of *Cady, Roberts* indicate a trend toward the elimination of all insider purchasing. But even were the Court prepared to accept the proposition that all insider trading is unfair, a proposition of doubtful validity at best, it would be deterred by the admonition of Judge Learned Hand that it is not "desirable for a lower (5479) court to embrace the exhilarating opportunity of anticipating a doctrine which may be in the womb of time, but whose birth is distant. . . ." *Spector Motor Service Inc.* v. *Walsh,* 139 F. 2d 809, 823 (2d Cir. 1944) (dissenting opinion) (reprinted in Bar Bulletin, N. Y. Co. Lawyers Assn, Vol. 23, No. 4, at 156, 1965-66). Therefore the purchases prior to 7:00 p.m. on April 9 were not based on material undisclosed information even if the purchasers had educated guesses based on the results of the first drill hole.

K-55-3

K-55-3 established that K-55-1 had not gone down dip, and indicated a vertical plane on section 2400 S containing mineralization. However there was no indication that the

mineralization extended beyond the plane. Defendant Mollison testified that at Kamkotia a drill hole could produce substantial mineralization while another 50 feet away produced a barren core. The results of K-55-3 added to the information previously known but did not constitute material information. If disclosed, it would not have had a substantial impact on the market price of the Company's stock.

Accordingly, the purchases made by certain defendants prior to 7:00 p.m. on April 9, 1964 were not based (5480) on material information. The fact that subsequent drilling established a major ore body is immaterial. As stated recently in *Value Line Fund, Inc.* v. *Marcus,* CCH FED. SEC. L. REP. ¶91,523,, at 94,956 (S.D.N.Y. 1965), "the court must be guided not by hindsight, but by the facts as they existed at the time of the . . . challenged transaction."

Similarly, purchases by Darke's "tippees" prior to 7:00 p.m. on April 9 were not made on the basis of material undisclosed information. Toward the end of December, 1963, Darke visited Caskey and Atkinson in Washington. The evidence shows no more than that Darke indicated to them that he thought TGS was a good buy. There is no direct evidence that Darke again communicated with any of his "tippees," but the record shows that on March 30, 1964 Darke and his "tippees," Atkinson, Caskey, E. W. Darke, Klotz, Miller and Westreich, purchased substantial amounts of TGS stock and calls on TGS stock. As the Commission points out, this is strong circumstantial evidence that Darke must have passed the word to one or more of his "tippees" that drilling on the Kidd 55 segment was about to be resumed. But, for the reasons hereinbefore stated, this information was not material.

(5481) For the foregoing reasons, the Court finds no violations of Section 10(b) or Rule 10b-5 on the part of any of the individual defendants who purchased shares of TGS or calls on TGS stock or recommended such purchases to others prior to 7:00 p.m. on April 9, 1964.

(2) *7:00 p.m. April 9, 1964 to 10:00 a.m. April 16, 1964*

Defendant Clayton purchased 200 shares of TGS stock on April 15; defendant Crawford purchased 600 shares on April 16. These defendants (and defendants Coates and Lamont) raise the defense that even if they were in possession of material information when they made their purchases, the material information had already become a matter of public knowledge.

The trial developed that rumors of an ore discovery by TGS were flying around Canada during the early part of April and were being given wide circulation in the Canadian press. These rumors reached the New York press by April 11, on which day they were played up in both the *New York Times* and the *New York Herald Tribune*. At this point defendants Stephens and Fogarty agreed that a press release was necessary and this decision led to the issuance of the April 12 press release hereafter discussed. Fogarty (5482) also gave instructions that a reporter from *The Northern Miner* (an important Canadian publication on the mining industry in Canada), who had previously been invited to visit the Kidd 55 segment on April 21, be asked to come on April 13 instead.

The Northern Miner reporter, Ackerley, visited the property on April 13, interviewed defendants Mollison, Holyk and Darke, looked at the records of the drilling to that time, and prepared an article for publication. The article stated in part that "The Northern Miner can say that a

major new zinc-copper-silver mine is definitely in the making, one that has all the earmarks of shaping into a substantial open pit operation . . . something in excess of 10,000,000 tons of ore is indicated." Ackerley delivered a copy of his proposed article to defendant Mollison in Timmins and it was agreed that it would not be published until cleared by Mollison. Defendants Mollison and Holyk read the article and though they felt that some of its conclusions were too optimistic, they considered it Ackerley's article and would not quibble with it. Defendant Mollison returned the article to *The Northern Miner* on the evening of April 15, and it was published in *The Northern Miner's* April 16 edition.

(5483) *The Northern Miner* had a small circulation in the United States—7,400 subscribers—including distribution in the New York area to 1,412 subscribers, who presumably received the paper on the morning of April 16. *The Northern Miner* also had a small newsstand circulation in New York, but the evidence fails to establish when the April 16 edition reached the newsstands. Reports of *The Northern Miner* article were telephoned and telexed from Toronto to some brokers in New York early on the morning of April 16 prior to the opening of the New York Stock Exchange.

The annual convention of the Canadian Institute of Mining and Metallurgy was held at the Queen Elizabeth Hotel in Montreal on April 13-15, attended by 500 to 600 representatives of the mining industry and of the business world, including some representatives from the United States. The rumors with respect to a copper discovery by TGS near Timmins were a leading subject of gossip in the corridors and bars of the hotel. The convention was attended by the Ontario Minister of Mines and his Deputy.

On the morning of April 15, defendants Mollison and Holyk met the Minister of Mines and his Deputy at the (5484) Montreal airport and flew them to Toronto, informing them during the course of the flight of the current developments on the Kidd 55 segment. The Minister indicated a desire to make a public statement and Mollison assisted him by drafting that statement. Mollison's draft concluded by saying that "the information now in hand . . . gives the company confidence to allow me (the Minister) to announce that TGS has a minable body of Zn, Cu, Ag ore of substantial dimensions that will be developed and brought to production as rapidly as possible." Mollison and Holyk were under the impression that the Minister would issue the statement in Toronto over radio and television at 11:00 p.m. on the evening of April 15 and Mollison so informed defendants Stephens and Fogarty in New York.

The Minister made no announcement on the evening of the 15th, but on the morning of the 16th, at about 9:40 a.m., he delivered the statement drafted by Mollison to the press gallery at the Ontario Parliament in Toronto. Members of the press gallery included representatives of both the Canadian and American news media, but there was no evidence as to who was in the press gallery at the time.

The effect of the foregoing was that before the market opened on April 16, some brokers and some speculators (5485) had picked up information that TGS had made an ore discovery. However, no announcement had yet been made by TGS. Only the day before, defendants Stephens, Fogarty and Crawford were preparing the announcement which was to be made at 10:00 a.m. on April 16. They took steps to assure the attendance of appropriate representatives of the news media at the press conference where the announcement would be made. The officers of TGS knew

about the rumors in Canada, the *Northern Miner* article and the pending announcement of the Ontario Minister of Mines. Had they thought that their effect was to make the material information public there would have been little purpose in making the arrangements for a press conference, and issuing a detailed announcement on April 16. The material information did not become public knowledge prior to TGS's official announcement. Therefore, insiders who purchased stock prior to TGS's announcement may not assert as a defense that the material information had already become a matter of public knowledge.

Turning now to the two defendants who purchased shares of TGS after 7:00 p.m. on April 9, 1964 and before 10:00 a.m. on April 16:

Richard H. Clayton

Clayton was a geophysicist in the employ of TGS. His job was to conduct geophysical surveys, and he conducted such surveys on the Kidd anomaly. While he did not participate (5486) in the drilling, he spent a great deal of his time at Timmins and at the Kidd 55 segment, and the evidence establishes that he kept himself fully informed. He was in Timmins on April 12 and 13 and, according to Adelstein, he told Adelstein (on June 3, 1964) that he thought TGS had a mine when he learned the results of K-55-4. While Clayton denied making this statement, he testified at a pre-trial examination that he thought that, with the results of K-55-6, TGS had a potential ore body. By 7:00 p.m. on April 13, K-55-6 had been drilled to 949 feet, encountering substantial mineralization. Indeed, no further mineralization was encountered by K-55-6 after that time. On April 14 Clayton left for New York and was in TGS's New York

office on April 15. He picked up the telephone at TGS's office in New York, called his broker in Toronto and ordered 200 shares of TGS stock. The broker executed the order on April 15 on the Midwest Stock Exchange in Chicago at 29⅜.

It is clear that at the time of this purchase Clayton was in possession of material inside information which had not yet been made available to the public and that he used this information to his own advantage. In this proceeding by the Commission it is immaterial whether (5487) Clayton intended to deceive or to defraud anyone or whether he knew at the time that his purchase would violate Section 10(b) and Rule 10b-5. The Commission has established that Clayton violated these provisions in making his April 15 purchase.

Clayton contends that he is not subject to the jurisdiction of this court. He was employed by TGS, a United States corporation, and, according to his testimony, shuttled back and forth between Canada and New York on TGS business during the period from November 1963 to April 1964. His April 15 purchase was initiated by him while he was in New York in TGS's office. He placed his order with his Toronto broker by telephone from New York to Canada, employing a channel of interstate and foreign commerce. The transaction was consummated on the Midwest Stock Exchange in Chicago. He had previously purchased TGS stock, and on two occasions his orders were executed on the New York Stock Exchange. Though he placed his orders with a Toronto broker, all his purchases were effected on an American stock exchange. Clayton's telephone call from New York on April 15 brought about the purchase. Therefore, the court has subject matter jurisdiction. (Section 27 of the Act, (5488) 15 U.S.C. 78aa; *Ferraiola* v. *Cantor,* CCH FED. SEC. L. REP. ¶91,704 (S.D.N.Y. 1966)). Under Sec-

tion 27 Clayton could be served wherever he was found and service outside of the United States has been sustained. *Ferraiola* v. *Cantor, supra; S.E.C.* v. *VTR Inc.*, CCH FED. SEC. L. REP. ¶91,618 (S.D.N.Y. 1966); *S.E.C.* v. *Briggs*, 234 F. Supp. 618 (N.D. Ohio 1964); see Advisory Committee's Note to the 1963 revision of Rule 4 of Fed. R. Civ. P. reprinted at 31 F.R.D. 627, 630 (1962). Service upon Clayton by leaving the summons and complaint with his wife at his home in Timmins was valid. (Rule 4(d)(1), (e), (f), Fed. R. Civ. P.)

DAVID M. CRAWFORD

Crawford is a lawyer who came with TGS on February 20, 1964, on which date he was appointed secretary of the Company and manager of its public and Government relations. He had not been informed as to the developments on the Kidd 55 segment. He read the rumor article in the *New York Herald Tribune* on April 11 while on his way to Houston to prepare for TGS's annual stockholders' meeting. He returned to New York either late on the 14th or early on the 15th of April, and on that day participated with Fogarty (5489) and a representative of Doremus & Co. in the preparation of the April 16 press release. The evidence establishes that by the evening of April 15 he was fully familiar with the contents of the announcement which was to be made the following morning. He spent the night in a room maintained by TGS at the Drake Hotel in New York City. About midnight he telephoned his broker in Chicago and ordered 300 shares of TGS for himself and his wife to be purchased as soon as the market opened the following day. During the night he decided to increase his order, and he telephoned his broker again at about 8:30 a.m. on April 16 to increase the order from 300 shares to 600 shares. The purchase was

executed on the Midwest Stock Exchange on April 16 at 30⅛ to 30¼.

Here again, while there is no evidence that Crawford intended to deceive or to defraud anyone, it is clear that he sought to, and did, "beat the news." There is no doubt that he believed that he could get the stock more cheaply if he bought before TGS's announcement was made. In so doing, he was utilizing material undisclosed information to his own advantage and violated Section 10(b) and Rule 10b-5. (5490)

(3) *10:00 a.m. April 16 to Close of Business on that Day*

Between the announcement and the close of business on April 16 defendants Coates and Lamont either purchased shares of TGS or recommended their purchase to others.

A regular meeting of the Board of Directors was held at TGS's offices at 9:00 a.m. on April 16. During the meeting defendant Stephens distributed copies of the announcement to be made to the press at the press conference called for 10:00 a.m. Stephens also told the Board that a statement regarding TGS's discovery had been issued in Toronto at 11:00 p.m. the previous evening by the Ontario Minister of Mines. At the conclusion of the Directors' meeting, representatives of the news media, over 22 in all, came into the Board Room. The announcement was made by Stephens, and they were given copies of the press release which Stephens, Fogarty and Crawford had prepared. The press release stated in part:

> "Texas Gulf Sulphur Company has made a major strike of zinc, copper and silver in the Timmins area of Ontario, Canada.
>
> • • • • •

"Seven drill holes are now essentially complete and indicate an ore body of at least 800 feet in length, 300 feet in width and (5491) having a vertical depth of more than 800 feet.

• • • • •

"This is a major discovery. The preliminary data indicate a reserve of more than 25 million tons of ore. The only hole assayed so far represents over 600 feet of ore, indicating a true ore thickness of nearly 400 feet.

• • • • •

"Visual examination of cores from the other holes indicate comparable grade and continuity of ore.

"The ore body is shallow, having only some 20 feet of overburden. This means that it can easily be mined initially by the open pit method."

• • • • •

Summaries of the announcement were carried over the internal news wire of Merrill Lynch, Pierce, Fenner & Smith at 10:29 a.m., and over the Dow Jones broad tape between 10:54 a.m. and 11:02 a.m.

Francis G. Coates

Coates was a Houston lawyer and a member of the Board of Directors of TGS. After reading the *Herald Tribune* article of April 11 he telephoned defendant Stephens from Houston and was told by Stephens that TGS did not have (5492) enough information to know what it had. Coates

came to New York on April 15 and saw a draft of the proposed April 16 announcement that afternoon. On the 16th he attended the Directors' meeting and remained for the press conference at which the announcement was made. The press conference started at 10:00 a.m. and lasted ten or fifteen minutes. Shortly before 10:20 a.m. Coates left the meeting room and telephoned his son-in-law, Haemisegger, a broker in Houston. He told Haemisegger of TGS's discovery and ordered 2,000 shares of TGS stock for the accounts of four family trusts of which he was a trustee but not a beneficiary. Haemisegger executed the order at prices from 31 to 31⅝ on the New York and Midwest Exchanges. Haemisegger immediately imparted the information he had received from Coates to four of his customers, and they, as well as Haemisegger himself, purchased a total of 1500 shares of TGS stock at prices ranging from 31¼ to 35.

Coates lost no time in telephoning his son-in-law in order to purchase TGS stock for his family trusts. Coates could not, as could Lamont when he telephoned Hinton at the Morgan Guaranty Trust Company just before 10:40 a.m. assume "without thinking about it, that the [ore discovery] (5493) was already a matter of public information. . . ." *Cady, Roberts, supra,* at 917. The announcement had been made, however, and it has been the generally accepted rule that it is the making of the announcement that controls. For example, the Commission in *Cady Roberts* found violations of Section 10(b) and Rule 10b-5 for purchases made "during the time when respondents should have known that the board of directors . . . was taking steps to make the information publicly available but *before it was actually announced.*" *Cady, Roberts, supra,* at 915. (Emphasis supplied.) Coates, an experienced corporate lawyer, testi-

fied that he believed that the standard in the marketplace was that once the announcement is made, insiders were free to purchase stock or to recommend it to others.

It may be, as the Commission contends, that a more effective rule should be established to preclude insiders from acting on information after it has been announced but before it has been absorbed by the public. Perhaps such a rule should extend not only to corporate insiders but to others who may be in a position to take unfair advantage of the stockholders. What of a representative of the news media who, upon hearing the announcement, calls his broker before he calls (5494) his office? What of a wire house which has an inside track in getting the information to its registered representatives and to its customers? (The April 16 announcement went out over Merrill Lynch's news wire to its 145 offices half an hour before it went out over the Dow Jones ticker.) Should the representatives of the news media and the wire houses be subjected to such a rule since they are in possession of material information which the average stockholder has not had an opportunity to absorb? These examples are offered merely to illustrate the problems that arise if the present practice is to be changed.

The Commission took the position, on summation, that it is for the courts to fix a reasonable waiting period after an announcement is made, during which insiders cannot purchase stock, so that the announcement can first be absorbed by the public. In other words, it seems to be the Commission's position that a fairer practice than now exists should be evolved through court decisions. This could only lead to uncertainty. A decision in one case would not control another case with different facts. No insider would know whether he had waited long enough after an announcement had been made. He would be subject to suit by the Com-

mission (and to private (5495) suits brought by others riding on the Commission's coattails).

The Commission has not supplied, nor has the Court found, decisions specifying a waiting period after a corporate announcement is made. After this action was instituted, Cary, the former chairman of the Commission, and Fleischer, his former executive assistant, discussed a waiting period in policy terms.[12] If a waiting period is to be fixed, this could be most appropriately done by the Commission, which was established by Congress with broad rule-making powers. Should the Commission determine that it lacks authority to fix a waiting period, authority should come from Congress rather than from the courts.

Since TGS's announcement had been made when Coates telephoned Haemisegger, he did not violate Section 10(b) or Rule 10b-5.

THOMAS S. LAMONT

Lamont was a director of TGS. He was also a director of Morgan Guaranty Trust Company and a member of its Executive Committee and its Trust and Investment Committee. (5496) Lamont testified that he first heard of the exploration on the Kidd 55 segment on April 10 when defendant Stephens telephoned him about the rumors in Canada, and Lamont advised Stephens to ignore them unless they reached the New York press. Stephens informed Lamont that the exploration was "at the prospect stage."

Thereafter, Lamont heard rumors from friends and read the article which appeared in the *Herald Tribune* on April 11, and TGS's April 12 press release as reported in the press. On April 13 or 14 he had a conversation about the rumors with Hinton, the Executive Vice President of Mor-

gan Guaranty Trust Company. Lamont told Hinton that he knew nothing more than had appeared in the press. On April 15 Lamont was informed by Stephens that a press conference would follow the regular Directors' meeting scheduled for the morning of the 16th. Lamont attended the Directors' meeting and read the press release, and attended the press conference at which the announcement was made.

Following the announcement, and while he was still at the TGS office, Lamont telephoned Hinton about 10:40 a.m. and told Hinton that good news about TGS had come out or would be shortly coming out on "the tape." Immediately (5497) following Lamont's telephone call, Hinton telephoned his trading department and was informed that TGS stock was active and up three points. Hinton thereupon placed an order for 2,000 shares of TGS for the account of the Bank's customer, the Nassau Hospital, which order was executed at about 10:41 a.m. Thereafter, Hinton placed further orders for purchases of TGS stock for customers of the Bank, including pension trusts, purchasing a total of 10,000 shares at prices ranging from 32⅝ to 34. At about 12:30 p.m. on April 16 Lamont ordered the purchase of some 3,000 shares of TGS for himself and members of his family, which orders were executed at a price of 34½.

Lamont's telephone call to Hinton was made some 20 minutes after Coates telephoned his son-in-law, both calls being made after the announcement. His own purchases were ordered more than two hours after the announcement.

For the reasons previously stated with respect to defendant Coates, Lamont did not violate Section 10(b) or Rule 10b-5, since the announcement had been made.[13]

(5498) ***Stock Options issued by TGS to certain defendants on February 20, 1964.***

Five of the defendants—Stephens, Fogarty, Kline, Mollison and Holyk—are charged with violating Section 10(b) and Rule 10b-5 by accepting stock options voted to them on February 20, 1964 by the Directors' Committee to Administer the Restricted Stock Option Incentive Plan (the Committee).[14] The Commission contends that these defendants violated the statute and the rule because they had knowledge as to the drilling results of the first hole, K-55-1, which knowledge they failed to disclose to the Committee or to the Board of Directors prior to accepting their options.

TGS's restricted Stock Option Incentive Plan (the Plan) was inaugurated in 1961 with the approval of its stockholders.[15] Three non-management directors, John H. Hill, Leslie M. Cassidy and defendant Coates, were the members of the Committee appointed by the Board. At the meeting of the Committee held on February 20, 1964, two members, Hill and defendant Coates, were present. The minutes disclose that the Board of Directors at its meeting on March 16, 1961 had directed that no shares should be (5499) optioned to any employee earning less than $24,000 annually. The Committee granted stock options to 21 officers and employees earning $24,000 or more per annum (including defendants Stephens, Fogarty, Mollison and Kline) and recommended to the Board the granting of stock options to five employees (including defendant Holyk) whose annual salaries were in the $15,000 to $21,000 range, which recommendation was approved by the Board at its meeting later on the same day.

The use of stock option plans is a commonly accepted device to provide incentive to officers and employees. Restricted stock options of the type authorized by the stock-

holders of TGS are not uncommon in publicly-owned companies. As pointed out by Judge Weinfeld in *Kornfeld* v. *Eaton*, 217 F. Supp. 671, 677 (S.D.N.Y. 1963), *aff'd* 327 F. 2d 263 (2d Cir. 1964):

> " . . . Restricted stock options of the type here under consideration have their genesis in express approval by the stockholders of the corporation and are intended to enable its employees to benefit from an increase in the market value of the security. The corporate purpose is satisfied through the optionee's services and his efforts to further its interests. Indeed it is in the corporate economic interest that its employees have an investment stake in it. Congress itself has recognized the salutary purpose of such plans by extending them favorable tax treatment."

(5500) The Committee necessarily relied on information furnished it by the higher echelon of TGS's management (which would include defendants Stephens and Fogarty, but not Mollison, Kline or Holyk). The Committee did not inquire of the recipients what special knowledge they might have as to various phases of TGS's business as it was entitled to rely on the information furnished by the management.

The record shows that at the time they accepted their stock options, each of the five defendants (except Kline) knew of the situation on the Kidd 55 segment as it existed at the time. Since the land acquisition program had not been completed they had been instructed not to divulge this information. Indeed, on February 20, 1964, neither the Board of Directors nor the Committee had been informed.[16]

Defendant Kline was informed by defendants Stephens and Fogarty at lunch in November 1963 that TGS was con-

ducting explorations in the Timmins area and that the completion of the first drill hole was a favorable development; that it was on the boundary of the TGS property and that TGS was interested in acquiring additional property. He knew no details and his only information came from his (5501) superiors. Defendants Mollison and Holyk knew the results of K-55-1 and had reported these results to their superior, defendant Fogarty. Kline, Mollison and Holyk had no duty to inform the Committee of information already known to their superiors since they could assume that such information would be reported to the Committee by the management.

Defendants Stephens and Fogarty as President and Executive Vice President were management. Both were also Directors and potential recipients of stock options. They were under a duty to inform the Committee of material information affecting the issuance of the stock options. The Plan required that the option price be at least 95% of the fair market value of the stock on the date on which the options are to be granted. The Committee fixed the option price as "the average of the highest and lowest prices of the Company's stock on the New York Stock Exchange during February 20, 1964." Therefore, included in Stephens' and Fogarty's duty of disclosure was any material information bearing on the market value of TGS stock on that date.

A corporate officer may be guilty of fraud if he withholds material information from his company to his own advantage. *New Park Mining Co.* v. *Cranmer,* 225 F. Supp. 261 (S.D.N.Y. 1963). Therefore, if the information known (5502) to defendants Stephens and Fogarty would have substantially affected the price of the TGS stock on the New York Stock Exchange, their receipt of stock options

without disclosure to the Committee could have constituted a fraud on TGS. A stock option is a security (the Act, Section 3(a)(10); 15 U.S.C. 78c(a)(10)), so that such a fraud would have come within the ambit of Section 10(b) and Rule 10b-5. See *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2d Cir. 1964).

On February 20, 1964, defendants Stephens and Fogarty knew (1) that K-55-1 had been completed; (2) that the drill core had been assayed and that the assay certificates showed substantial mineralization; and (3) that the land acquisition program was in progress and that further drilling would await its completion. However, the Court has already determined that the information as to developments on the Kidd 55 segment were not material until 7:00 p.m. on April 9, some seven weeks later. The same definition of materiality applies. Since the information was not material, defendants Stephens and Fogarty were not required to disclose it to the Committee. Hence, defendants Stephens and Fogarty were not guilty of fraud or deception in failing to furnish the information. In (5503) view of the land acquisition program, the security measures which they established were for the benefit of the Company and its stockholders.[17]

In accepting the stock options granted to them on February 20, 1964, defendants Stephens, Fogarty, Kline, Mollison and Holyk did not violate Section 10(b) or Rule 10b-5.

The April 12, 1964 Press Release

On Sunday, April 12, 1964, at about 3:00 p.m., TGS issued a press release, the substance of which appeared in the Monday morning newspapers. The text of the release stated in part:

"NEW YORK, April 12—The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:

" 'During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.

" 'The facts are as follows. TGS has been exploring in the Timmins area for six (5504) years as part of its overall search in Canada and elsewhere for various minerals—lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.

" 'Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.

" 'Recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

" 'The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project.' "

* * * * *

(5506) The Commission argues that at the time the press release was issued, TGS knew that it had discovered a copper mine on the Kidd 55 segment and that the press release was materially misleading in characterizing this discovery as a "prospect" and in stating that "any statement as to size and grade of ore would be premature." For these reasons the Commission contends that the press release violated Section 10(b) and Rule 10b-5.

TGS denies that the press release was false or misleading. Moreover, TGS contends that no violation of Section 10(b) or Rule 10b-5 is made out by the Commission since the press release was not issued "in connection with the purchase or sale of any security." However, the issuance of a false and misleading press release may constitute a violation of Section 10(b) and Rule 10b-5 if its purpose is to affect the market price of a company's stock to the advantage of the company or its insiders. *Freed* v. *Szabo*

Food Serv., Inc., CCH FED. SEC. L. REP. ¶91,317 (N.D. Ill. 1964). The phrase "in connection with the purchase or sale of any security" has been broadly construed "to carry out the intent of the Act, which is designed to protect investors against fraud." *Stockwell* v. *Reynolds & Co.*, (5507) CCH FED. SEC. L. REP. ¶91,579 at 95,198 (S.D.N.Y. 1965); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964).

During the first week of April, rumors of a copper discovery by TGS on the Kidd 55 segment were circulating in Canada. These rumors intensified, and on April 9 Toronto newspapers reported that TGS had discovered "one of the largest copper deposits in North America," "a major copper strike." On April 10, defendant Stephens telephoned defendant Lamont seeking his advice as to what action TGS should take with respect to the rumors. Lamont advised that TGS should take no action unless the rumors reached the New York press or until TGS had sufficient information available to issue an appropriate press release.

On Saturday morning, April 11, 1964, defendant Stephens, while at his home in Greenwich, Connecticut, read the articles appearing in the *New York Times* and the *New York Herald Tribune*. The *Herald Tribune* article announced that TGS had "the biggest ore strike since gold was discovered more than 60 years ago in Canada . . . a bed of copper sulphide 600 feet wide with a possible overall copper return of 2.87% through most of its width."; (5508) that TGS had four drill rigs in operation with four more to go into operation the following week; and that the richness of the copper was so great that it had been flown out of Canada to be assayed.

Stephens telephoned defendant Fogarty at the latter's home in Rye, New York and told him about the articles. Fogarty read the articles and called Stephens back. Fogar-

ty testified that he and Stephens "were quite upset . . . because certainly they [the articles] were full of exaggerations and what I considered to be erroneous statements." Stephens advised Fogarty that TGS should issue a press release to clarify the rumors, referring to his April 10 conversation with defendant Lamont. Stephens asked Fogarty to contact Carroll of Doremus & Co., the Company's public relations firm, who also lived in Rye. Fogarty did so, and Carroll agreed that TGS should issue a press release.

At about 1:00 p.m. on Saturday afternoon, April 11, Fogarty telephoned defendant Mollison at his home in Greenwich, Connecticut, and asked for a review of the situation at the Kidd 55 segment. At about 5:00 p.m. he went to Mollison's home to discuss the matter further. Mollison had been on (5509) the Kidd 55 segment on the morning of April 10 and had been advised by defendant Holyk as to the drilling results to 7:00 p.m. on April 10. At that time drill holes K-55-1, K-55-3 and K-55-4 had been completed; drilling of K-55-5 had started on Section 2200 S and had been drilled to 97 feet, encountering mineralization on the last 42 feet; and drilling of K-55-6 had been started on Section 2400 S and had been drilled to 569 feet, encountering mineralization over the last 127 feet.

In reporting the situation on the Kidd 55 segment, Mollison told Fogarty that the only known mineral occurrences in the area had been at Kamkotia and that these consisted of a series of small disconnected sulphide masses. Mollison advised that it was too early to state what TGS had and "it was impossible at that time . . . to understand the structure, to make the projections from one hole to another." Fogarty went home and drafted notes for a press release which he took to Carroll's house so that they could be put in shape by Carroll for release on Sunday, the following day. He had telephoned defendant Hunting-

ton, one of TGS's lawyers, reading his notes to him. Huntington made one or two suggestions and advised Fogarty that he thought the release would be all right legally.

(5510) On Sunday morning, April 12, Fogarty telephoned Mollison to see if he had any additional information, and instructed Mollison to return with Holyk to Timmins as soon as possible to "move things along." Fogarty and Carroll then completed the final draft of the press release at Carroll's house. Fogarty telephoned Stephens and read the final draft to him, Stephens asking certain questions and making minor changes. Stephens instructed Fogarty to have the release issued as promptly as possible so that it would be on the wires on Sunday afternoon.

From the foregoing, it is pparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment. There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage. The issuance of the release produced no unusual market action. In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or (5511) Rule 10b-5 since it was not issued "in connection with the purchase or sale of any security."

However, even if it had been established that the April 12 release was issued in connection with the purchase or sale of any security, the Commission has failed to demonstrate that it was false, misleading or deceptive. The significance of the drilling results known to TGS by 7:00 p.m. on April 10 was the subject of detailed and conflicting tes-

timony at the trial. Adelstein defined proven ore and probable ore. His definitions were substantially the same as the definitions used in the General Rules and Regulations under the Securities Act of 1933, Appendix I, Form 1-A, Notification Under Regulation A, Schedule I, Item 8A(c), which provide:

> "The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore."

Based on these definitions and the drilling done to 7:00 p.m. on April 10, Adelstein was of the opinion that TGS could have calculated 8.33 million tons of proven ore. Pennebaker, (5512) the other Commission expert, was of the opinion that TGS could have calculated 6.2 million tons of proven ore. Both of the Commission experts stressed that the drilling showed substantial mineralization in the cores and substantial copper mineralization on the eastern edge of the anomaly. Since they could make estimates as to the size and grade of ore on the basis of information to 7:00 p.m. on April 10, the Commission contends that the use of the word "prospect" in the April 12 press release was misleading. Adelstein defined a "prospect" as a property where there is no assurance that commercially mineable reserves exist.

The opinions of Adelstein and Pennebaker were contradicted by Forrester, Park, Wiles, Walkey, Lacy and McLaughlin, independent experts called by TGS (see footnote (9)).

(5513) TGS's experts were unanimously of the opinion that at 7:00 p.m. on April 10 the Kidd 55 segment was still a prospect and that no estimates as to proven or probable ore could be made. They all agreed that the April 12 press release accurately set forth the situation as it was known at the time. None thought that TGS could have estimated proven ore, and the Commission's expert, Pennebaker, agreed that this was a matter on which there could be differences of opinion. Defendants' experts testified that on the basis of the drilling to that time there was no assurance of continuity in the mineralized zone and that, without further drilling, the results of one hole could not be correlated with the results of others.

The Commission contends none the less that the press release was misleading and deceptive because the defendants who prepared the release believed that TGS had a mine. The Commission points to the fact that drilling of K-55-8, the mill test hole, was commenced on April 11, and must have been ordered by the defendants at an earlier time. Both Adelstein and Pennebaker testified that a company does not drill a mill test hole on a "prospect."

(5514) Park, Lacy and Forrester found nothing unusual in this procedure, and Wiles testified that it was usual to begin collecting metallurgical samples as the drilling progresses. With a direct conflict in testimony between the Commission's and defendants' expert witnesses, it cannot be concluded that instructions to drill K-55-8 established that TGS knew that the Kidd 55 segment was no longer a "prospect."

The Commission also points to the *Northern Miner* article which was drafted in Timmins on April 13. Even if it is assumed that Mollison, Holyk and Darke suggested the contents of that article to Ackerley, this would not establish that the April 12 press release was false or deceptive. Using

the Commission's figures, over 30% of the relevant drilling was done between 7:00 p.m. on April 10 and 7:00 a.m. on April 13. K-55-5 was drilled an additional 507 feet; K-55-6 was drilled an additional 375 feet; drilling of K-55-7 was commenced on April 12 on Section 2000 S and was drilled to a length of 146 feet by 7:00 a.m. on April 13. The defendants are to be judged on the facts known to them when the April 12 press release was issued. Mollison and Holyk were not at the site but were in or near New York (5515) while the release was being prepared. There is no evidence that the drilling results after 7:00 p.m. on April 10 were known to the framers of the April 12 press release, so there is no more reason for charging TGS with this knowledge than with knowledge of the statement drafted by Mollison for the Ontario Minister of Mines on April 15, or with knowledge of the information that was available to TGS when it made its announcement on April 16.

Moreover, the circumstances under which the April 12 release was prepared indicate that defendants Fogarty and Mollison were under considerable pressure. If they said too much, they would have been open to criticism and possible liability if it turned out that TGS had not discovered a commercial mine. If they said too little and later announced a mine, they subjected themselves to the charge that their press release was misleading or deceptive—and, indeed, this is what has happened. If they had announced the drilling results in terms of number of drill holes, footage drilled and mineralization intersected, they would have encouraged the rumor mill which they were seeking to allay. Perhaps they should have waited until they could have obtained more probative information before issuing a press release, particularly (5516) since developments were breaking so rapidly. However, as above stated, TGS must not be judged by hindsight. In seeking the advice of Mollison, the

head of TGS's exploration group, in consulting with TGS's public relations firm, and in clearing the release with one of TGS's lawyers, Stephens and Fogarty exercised reasonable business judgment under the circumstances. While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known.[18]

Accordingly, in issuing the April 12 press release TGS did not violate Section 10(b) or Rule 10b-5.

Conclusion

The foregoing constitutes the Court's findings of fact and conclusions of law (Rule 52(a), Fed. R. Civ. P.).

There appearing no just reason for delay, the Clerk is directed to enter judgment dismissing the complaint against defendants Texas Gulf Sulphur Company, Charles F. Fogarty, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Thomas S. Lamont, Francis G. Coates, Claude O. Stephens, John A. Murray, Earl L. Huntington and Harold B. Kline (Rule 58(1), Fed. R. Civ. P.).

(5517) Defendants Richard H. Clayton and David M. Crawford are found to have violated Section 10(b) of the Act and Rule 10b-5. In accordance with the agreement between the parties, the Commission may notice a hearing to determine the remedy to be accorded with respect to these two defendants.

It is so ordered.

Dated: New York, N. Y.
August 16, 1966.

Dudley B. Bonsal
U. S. D. J.

Filed August 19, 1966

(5518) Footnotes to Opinion in Securities and Exchange Commission v. Texas Gulf Sulphur Company, et al. 65 Civ. 1182

(1) At least 49 private actions are now pending in this court against TGS, defendants named in the Commission's action, and others, arising out of the transactions which are the subject matter of the Commission's action. Some 16 of these are individual actions, 31 are said to be class actions, and one is a derivative action. At least 475 persons are included as plaintiffs. While many of the complaints do not specify the damages claimed, others, in the aggregate, claim compensatory damages in excess of $2,800,000 and punitive damages in excess of $77,000,000.

(2) Certain minerals combine with sulphur to form sulphides. Some sulphides, such as chalcopyrite (copper sulphide) and sphalerite (zinc sulphide), may be commercially mined if found in sufficient quantities; others, such as pyrite and pyrrhotite (iron sulphides), have no commercial value.

(3) The electromagnetic instruments used in the aerial geophysicial surveys indicate only that a conductor of electricity exists. There are many good conductors besides sulphides. For example, graphite and even water are good conductors. On the other hand, zinc sulphides are not conductors.

(4) Prior to April 7 a shortage of water needed for drilling prevented the operation of more than one drill rig. The second rig was put into operation on April 8, and the third and fourth rigs were put into operation on April 10 and 12 respectively.

(5) Seven feet of snow on the ground during this period impeded travel between the Kidd 55 segment and Timmins, 15 miles away, the trip taking as long as four hours.

(6) Rule 10b-5 is general in terms. Other rules under Section 10(b) are more specific. See Rule 10b-6, which applies Section 10(b) to underwriters, issuers, brokers, dealers, etc. Compare also Rule 10b-2 with reference to solicitation of purchases on an exchange to facilitate a distribution of securities.

(5519) (7) In its briefs and at trial the Commission made no distinction between the three sections of Rule 10b-5, rely-

ing on *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2d Cir. 1965), where the court noted that as long as a violation of the Rule is alleged, it makes little difference which section of the Rule is invoked. There was no evidence, however, that the defendants employed "any device, scheme, or artifice to defraud" under section (1) or made any representations under section (2). Therefore, only section (3) is applicable to the facts of this case.

(8) Section 206 provides in part that:

> "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; . . ."

(9) At the trial, the Commission called as expert witnesses Benjamin Adelstein and Edwin M. Pennebaker. Mr. Adelstein has been the Chief Mining Engineer for the Commission since 1941. He was previously employed by Anaconda Copper Company and by the United States Coast and Geodetic Survey and the United States Corps of Engineers. Mr. Pennebaker is a mining geologist from Scottsdale, Arizona with many years of experience, who was appointed Consulting Geologist to the Commission in November 1965.

TGS called as expert witnesses: James D. Forrester, geologist, Dean of the University of Arizona School of Mines and Director of the Arizona Bureau of Mines, Tucson, Arizona; Charles F. Park, Jr., geologist, Professor of Geology at Stanford University, where he was Dean of the School of Earth Sciences from 1950-1965; Cloyd M. Wiles, mining engineer with National Lead Company from 1942 until his retirement in 1963; Graham Walkey, mining engineer and geologist with Kamkotia Mines, which is located approximately 12 miles from the Kidd 55 segment; Willard C. Lacy, geologist, professor at the University of Arizona and head of the University's Department of Mining and Engineering; Donald McLaughlin, geologist, Chairman of the Board and formerly president of Homestake Mining

Company; John B. Boniwell, geophysicist with eight years' experience on the Canadian Shield; Douglas H. Bellemore, security analyst, Professor of Finance at the Graduate School of Business (5520) Administration at New York University; and Alvin W. Pearson, security analyst, president of Lehman Corporation and chairman of its Portfolio Committee.

(10) Adelstein testified that on the basis of work done to 7:00 p.m. on April 9 TGS could have calculated ore reserves of 7.7 million tons with a gross assay value of $204,200,000. Pennebaker testified that TGS could have calculated ore reserves of 5.5 million tons with a gross assay value of $197,200,000. Adelstein defined gross assay value to mean "the sum of the products of the number of units of each metal of commercial value times the prevailing price for each metal . . ." Since gross assay value does not take account of the costs of mining, milling, smelting, sales, overhead, cost of capital, etc., it can be misleading and its use in registration statements is prohibited by the Commission. For example, Wiles estimated that 95.2% of the gross assay value of the ore deposit on the Kidd 55 segment would be expended for the above purposes. Although his figures appear to be conservative and though ore with a much lower gross assay value than that on the Kidd 55 segment is commercially mined, his testimony illustrates why gross assay value is not a good indicator.

(11) Members of the TGS exploration group could not state with certainty that K-55-1 had not been drilled down dip. In a memorandum written on November 14, 1963, defendant Holyk stated that:

> "While there are some indications that the drill hole is drilling across the dip, there are also numerous instances of bedding and minerals stratification to be almost parallel to the core axis. Accordingly, it is impossible to estimate the true width of the sulphide zone until a second drill hole is directed across this intersection from west to east. It may well be that the zone is quite narrow in the event that the drill hole has been directed down dip."

The Commission offered testimony as to banding, mineral stratification within the drill core, to establish that K-55-1 had been drilled across the mineral zone and not down dip. The significance of banding, particularly without more drilling, was strongly disputed by defendants' experts.

(5520) (12) In a symposium held on November 22, 1965, former Commission Chairman Cary stated:

> "Directly related is the question when insiders can trade. Again, I doubt whether we can supply a definitive answer. In general, the answer may be: not prior to the time the news has been absorbed by the market. The President of the New York Stock Exchange has suggested thirty days, beginning one week after the distribution of a comprehensive annual report . . . This line, I think, is strict; it goes beyond law, and is really a policy doctrine that he has enunciated. It goes beyond what a lawyer might advise." (Symposium, "Insider Trading in Stocks, *The Business Lawyer*, Vol. XXI, 1009, 1014-1015 (1966).)

Fleischer has written:

> "As a general principle, an insider might be held to violate rule 10b-5 whenever he trades before the effect of the news in question has been absorbed by the market.
>
> • • • • •
>
> "As a matter of corporate practice, it would be advisable for any insider to forego any trading for, say, an arbitrary twenty-four hour period after important news is released to the public." (Fleischer, "Securities Trading and Corporate Information Practices: The Implications of the *Texas Gulf Sulphur Proceeding*," 51 *Va. L. Rev.* 1271, 1291 (1965).)

(13) Since no violations of Section 10(b) or Rule 10b-5 have been found as to those defendants who recommended TGS stock to others, it is not necessary to consider whether an insider who violates the Statute or the Rule may be liable for purchases made by his "tippees."

(14) The stock options accepted by these defendants were as follows:

Stephens	for	12,800	shares
Fogarty	"	7,300	"
Kline	"	4,300	"
Mollison	"	4,300	"
Holyk	"	2,000	"

Stock options were granted to 21 other officers and employees at the same time, and the total number of shares covered by stock options granted on February 20, 1964 was 89,950.

(5521) (15) The Plan provided that the options would run for ten years from the date of issue, subject to automatic termination in the event of the death or termination of employment of the recipient. At its meeting, the Committee recommended that the plan be amended to reduce the option period from ten years to five years, to become effective on passage of pending Congressional legislation to that effect; that such amendment apply to the options granted on February 20, 1964; and further, that the options issued on February 20, 1964 could not be exercised while any previous qualified or restricted option was held by the optionee. The options provided that the optionees could exercise up to 40% at any time after 18 months, 70% at any time after three years and 100% at any time after four years.

(16) The Board was not informed until its meeting on April 16, 1964, when the Directors were given copies of the press release which was issued following the meeting.

(17) After the Commission instituted this action, the Board of Directors, on July 15, 1965, ratified the issuance of the stock options to Kline, Mollison and Holyk. Stephens and Fogarty surrendered to TGS the options which they received, and these options have been cancelled.

(18) That the drilling results to 7:00 p.m. on April 9 have been held to be material information does not lead to the conclusion that the Kidd 55 segment was either a mine or a prospect twenty-four hours later. It means only that insiders could not use this material information to their own advantage prior to its disclosure to the public.

Appendix A — Judgment of the District Court (Entered August 22, 1966)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

The defendant Thomas P. O'Neill having been served with a summons and complaint, and said defendant having failed to answer or appear herein, and the plaintiff having moved for a default judgment in a separate proceeding, and all the remaining parties having waived a jury and having agreed that trial should first be had on the issue of whether defendants or any of them had violated Section 10(b) and Rule 10b-5 reserving for a later hearing the issue of the remedy to be applied in the event such violations are found, and the said issue having been brought on regularly for trial before the Honorable Dudley B. Bonsal, United States District Judge, on May 9, 10, 11, 12, 13, 23, 24, 25, 26, 27, 31 and June 1, 2, 3, 6, 7, 8 and 21, 1966, and the Court having reserved decision at the conclusion of the evidence, and the Court thereafter having handed down its opinion decision, dated August 16, 1966 and filed on August 19, 1966 constituting the Court's findings of fact and conclusions of law dismissing the complaint as to all defendants except Richard H. Clayton and David M. Crawford, and the Court having found that the defendants Richard H. Clayton and David M. Crawford had violated Section 10(b) of the Act and Rule 10b-5, and the Court in its opinion decision having stated that there was no just reason for delay of entry of this Judgment, it is

ORDERED, ADJUDGED AND DECREED: That the defendants, Texas Gulf Sulphur Company, a Texas corporation, Charles F. Fogarty, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Thomas S. Lamont, Francis G. Coates, Claude O. Stephens, John A. Murray, Earl L. Huntington and Harold B. Kline have judgment against the plaintiff Securities and Exchange Commission dismissing the complaint, and it is further,

ORDERED, ADJUDGED AND DECREED: That the defendants Richard H. Clayton and David M. Crawford have violated Section 10(b) of the Act and Rule 10b-5, and pursuant to agreement between the parties, the Securities and Exchange Commission may notice a hearing to determine the remedy to be accorded with respect to these two defendants.

Dated: New York, N.Y.
August 22, 1966

John J. Olear, Jr.
Clerk

Appendix A — Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 296—September Term, 1966.

(Argued March 20, 1967
Submitted to the *in banc* Court May 2, 1968
Decided August 13, 1968.)

Docket No. 30882

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

—v.—

TEXAS GULF SULPHUR Co., a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, WALTER HOLYK, KENNETH H. DARKE, FRANCIS G. COATES, CLAUDE O. STEPHENS, JOHN A. MURRAY, EARL L. HUNTINGTON, and HAROLD B. KLINE,

Defendants-Appellees.

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

—v.—

DAVID M. CRAWFORD and RICHARD H. CLAYTON,

Defendants-Appellants.

Before:

LUMBARD, *Chief Judge*,
WATERMAN, MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS,
ANDERSON and FEINBERG, *Circuit Judges*.

In the United States District Court for the Southern District of New York the Securities and Exchange Commission commenced its action pursuant to 15 U. S. C. §§78u, 78aa, against Texas Gulf Sulphur Company and thirteen individuals alleging violations by the fourteen defendants of the provisions of Section 10b of the Securities Exchange Act of 1934, 15 U. S. C. §78j(b), and its Rule 10b-5 (17 C. F. R. 240.10b-5) promulgated pursuant to the authority granted to it in Section 10b.

The court below, Bonsal, *J.*, found that two of the individual defendants, Clayton and Crawford, had violated Section 10b and Rule 10b-5, but otherwise the Commission's complaint was ordered dismissed, 258 F. Supp. 262 (1966).

Appeals were taken by the Commission and by Clayton and Crawford. Eleven of the thirteen original individual defendants, and the corporation, are parties in the proceedings before us.

The appeals were argued before a division of the court consisting of Judges Waterman, Moore, and Hays. When the opinions prepared by them were distributed to the other judges of the court it was ordered on May 2, 1968 that the case should, without further argument, be considered *in banc* upon the record and briefs the parties had filed and upon the opinions that had been prepared and distributed by the panel judges. After *in banc* consideration the opinions appearing hereafter were prepared. The results reached in Judge Waterman's opinion for the court are

concurred in unanimously as to appellee Coates, and appellants Clayton and Crawford; as to the remaining contested issues that opinion represents results concurred in either generally or in separate statements by a majority of the judges.

The dispositions below as to appellants Clayton and Crawford are affirmed. As to one of the appellees, Murray, the disposition below is affirmed. As to the remaining individual appellees and the corporation, the order dismissing the complaint is reversed and the cause remanded for further proceedings below consistent with the opinion of the court.

PHILIP A. LOOMIS, JR., Gen. Counsel; DAVID FERBER, Solicitor; ROGER S. FOSTER, Spec. Counsel, Ofc. of Policy Research, SEC; FRANK E. KENNAMER, JR., Asst. Gen. Counsel; DONALD M. FEUERSTEIN, Atty., SEC, *for Securities and Exchange Commission.*

ORISON S. MARDEN, White & Case, WILLIAM D. CONWELL, EDWARD C. SCHMULTS, P. R. KONRAD KNAKE, THOMAS MCGANNEY, PETER G. EIKENBERRY, New York City, *for Texas Gulf Sulphur, Fogarty, Mollison, Holyk, Darke, Stephens, Murray, Huntington and Kline, Crawford and Clayton.*

ALBERT R. CONNELLY, DONALD I. STRAUBER, Cravath, Swaine & Moore, New York City, *for Coates.*

WATERMAN, *Circuit Judge*:

This action was commenced in the United States District Court for the Southern District of New York by the

Securities and Exchange Commission (the SEC) pursuant to Sec. 21(e) of the Securities Exchange Act of 1934 (the Act), 15 U. S. C. §78u(e), against Texas Gulf Sulphur Company (TGS) and several of its officers, directors and employees, to enjoin certain conduct by TGS and the individual defendants said to violate Section 10(b) of the Act, 15 U. S. C. Section 78j(b), and Rule 10b-5 (17 CFR 240.10b-5) (the Rule), promulgated thereunder, and to compel the rescission by the individual defendants of securities transactions assertedly conducted contrary to law.[1] The complaint alleged (1) that defendants Fogarty, Mollison, Darke, Murray, Huntington, O'Neill, Clayton, Crawford, and Coates had either personally or through agents purchased TGS stock or calls thereon from November 12, 1963 through April 16, 1964 on the basis of material inside information concerning the results of TGS drilling in Timmins, Ontario, while such information remained undisclosed to the investing public generally or to the particular sellers[2]; (2) that defendants Darke and Coates had di-

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1 Pursuant to a stipulation by all parties, the question of the appropriate remedies to be applied was deferred pending a final determination whether the defendants or any of them had violated Section 10(b) and Rule 10b-5 and therefore that question is not now before us.

2 The purchases by the parties during this period were:

Purchase		*Shares*		*Calls*	
Date	*Purchaser*	*Number*	*Price*	*Number*	*Price*
Hole K-55-1 Completed November 12, 1963					
1963					
Nov. 12	Fogarty	300	17¾-18		
15	Clayton	200	17¾		
15	Fogarty	700	17⅝-17⅞		
15	Mollison	100	17⅞		
19	Fogarty	500	18⅛		
26	Fogarty	200	17¾		
29	Holyk (Mrs.)	50	18		
Chemical Assays of Drill Core of K-55-1 Received December 9-13, 1963					

(*footnote continued on next page*)

vulged such information to others for use in purchasing TGS stock or calls[3] or recommended its purchase while the

Purchase Date 1963	*Purchaser*	*Shares Number*	*Price*	*Calls Number*	*Price*
Dec. 10	Holyk (Mrs.)	100	20⅜		
12	Holyk (or wife)			200	21
13	Mollison	100	21⅛		
30	Fogarty	200	22		
31	Fogarty	100	23¼		
1964					
Jan. 6	Holyk (or wife)			100	23⅝
8	Murray			100	23¼
24	Holyk (or wife)			200	22¼-22⅝
Feb. 10	Fogarty	300	22⅛-22¼		
20	Darke	300	24⅛		
24	Clayton	400	23⅞		
24	Holyk (or wife)			200	24⅛
26	Holyk (or wife)			200	23⅝
26	Huntington	50	23¼		
27	Darke (Moran as nominee)			1000	22⅝-22¾
Mar. 2	Holyk (Mrs.)	200	22⅝		
3	Clayton	100	22¼		
16	Huntington			100	22⅝
16	Holyk (or wife)			300	23¼
17	Holyk (Mrs.)	100	23⅞		
23	Darke			1000	24¾
26	Clayton	200	25		
Land Acquisition Completed March 27, 1964					
Mar. 30	Darke			1000	25⅛
30	Holyk (Mrs.)	100	25⅞		
Core Drilling of Kidd Segment Resumed March 31, 1964					
April 1	Clayton	60	26½		
1	Fogarty	400	26½		
2	Clayton	100	26⅞		
6	Fogarty	400	28⅛-28⅜		
8	Mollison (Mrs.)	100	28⅛		
First Press Release Issued April 12, 1964					
April 15	Clayton	200	29⅜		
16	Crawford (and wife)	600	30⅛-30¼		
Second Press Release Issued 10:00-10:10 or 10:15 A.M., April 16, 1964					
April 16 (app. 10:20 A.M.)	Coates (for family trusts)	2000	31 -31⅝		

3 A "call" is a negotiable option contract by which the bearer has the right to buy from the writer of the contract a certain number of shares of a particular stock at a fixed price on or before a certain agreed-upon date.

information was undisclosed to the public or to the sellers;[4] that defendants Stephens, Fogarty, Mollison, Holyk, and

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4 The purchases made by "tippees" during this period were:

Purchase Date	Purchaser	Shares Number	Shares Price	Calls Number	Calls Price
Chemicals Assays of K-55-1 Received Dec. 9-13, 1963					
1963					
Dec. 30	Caskey (Darke)			300	22¼
1964					
Jan. 16	Westreich (Darke)	2000	21¼-21¾		
Feb. 17	Atkinson (Darke)	50	23¼	200	23⅛
17	Westreich (Darke)	50	23¼	1000	23¼-23⅜
24	Miller (Darke)			200	23¾
25	Miller (Darke)			300	23⅜-23½
Mar. 3	E. W. Darke (Darke)			500	22½-22⅝
17	E. W. Darke (Darke)			200	23⅜
Land Acquisition Completed Mar. 27, 1964					
1964					
Mar. 30	Atkinson (Darke)			400	25¾-25⅞
	Caskey (Darke)	100	25⅞		
	E. W. Darke (Darke)			1000	25¾-25⅞
	Miller (Darke)			200	25½
	Westreich (Darke)	500	25¾		
30-31	Klotz (Darke)			2000	25½-26⅛

Second Press Release Issued April 16, 1964 (Reported over Dow Jones tape at 10:54 A.M.)

April 16 (from 10:31 A.M.)

Haemisegger (Coates) 1500 31¼-35

In this connection, we point out that, though several of the Holyk purchases of shares and calls made between November 29, 1963 and March 30, 1964 were in the name of Mrs. Holyk or were in the names of both spouses, we have treated these purchases as if made in the name of defendant Holyk alone.

Defendant Mollison purchased 100 shares on November 15 in his name only and on April 8 100 shares were purchased in the name of Mrs. Mollison. We have made no distinction between those purchases.

Defendant Crawford ordered 300 shares about midnight on April 15 and 300 more shares the following morning, to be purchased for himself, and his wife, and these purchases are treated as having been made by the defendant Crawford.

In these particulars we have followed the lead of the court below. See the table at 258 F. Supp. 273-275 and the special references to the Holyk purchases at 273, and the Crawford purchases at 287. It would be unrealistic to include any of these purchases as having been made by other than the defendants, and unrealistic to include them as having been made by members of the general public receiving "tips" from insiders.

Kline had accepted options to purchase TGS stock on Feb. 20, 1964 without disclosing the material information as to the drilling progress to either the Stock Option Committee or the TGS Board of Directors; and (4) that TGS issued a deceptive press release on April 12, 1964. The case was tried at length before Judge Bonsal of the Southern District of New York, sitting without a jury. Judge Bonsal in a detailed opinion[5] decided, *inter alia,* that the insider activity prior to April 9, 1964 was not illegal because the drilling results were not "material" until then; that Clayton and Crawford had traded in violation of law because they traded after that date; that Coates had committed no violation as he did not trade before disclosure was made; and that the issuance of the press release was not unlawful because it was not issued for the purpose of benefiting the corporation, there was no evidence that any insider used the release to his personal advantage and it was not "misleading, or deceptive on the basis of the facts then known," 258 F. Supp. 262, at 292-296 (SDNY 1966). Defendants Clayton and Crawford appeal from that part of the decision below which held that they had violated Sec. 10(b) and Rule 10b-5 and the SEC appeals from the remainder of the decision which dismissed the complaint against defendants TGS, Fogarty, Mollison, Holyk, Darke, Stephens, Kline, Murray, and Coates.[6]

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5 258 F. Supp. 262 (SDNY 1966).

6 Defendant O'Neill did not appear to answer the charge against him; the SEC motion to enter a default judgment against him was denied without prejudice to its renewal upon completion of this appeal.

Shortly after the appeal was argued defendant Lamont passed away, and by agreement of the parties an order was entered discontinuing his appeal and directing that the judgment below dismissing the action against him be severed from the judgment as to the other defendants.

The SEC does not contest the alternative holding below that Holyk and Mollison, not being members of TGS's top management, had no duty of disclosure prior to acceptance of stock options.

For reasons which appear below, we decide the various issues presented as follows:

(1) As to Clayton and Crawford, as purchasers of stock on April 15 and 16, 1964, we affirm the finding that they violated 15 U. S. C. §78j(b) and Rule 10b-5 and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(2) As to Murray, we affirm the dismissal of the complaint.

(3) As to Mollison and Holyk, as recipients of certain stock options, we affirm the dismissal of the complaint.

(4) As to Stephens and Fogarty, as recipients of stock options, we reverse the dismissal of the complaint and remand for a further determination as to whether an injunction, in the exercise of the trial court's discretion, should issue.

(5) As to Kline, as a recipient of a stock option, we reverse the dismissal of the complaint and remand with directions to issue an order rescinding the option and for a determination of any other appropriate remedy in connection therewith.

(6) As to Fogarty, Mollison, Holyk, Darke, and Huntington, as purchasers of stock or calls thereon between November 12, 1963, and April 9, 1964, we reverse the dismissal of the complaint and find that they violated 15 U. S. C. §78j(b) and Rule 10b-5, and remand, pursuant to the agreement of all the parties, for a determination of the appropriate remedy.

(7) As to Clayton, although the district judge did not specify that the complaint be dismissed with respect to

his purchases of TGS stock before April 9, 1964, such a dismissal is implicit in his treatment of the individual appellees who acted similarly. Consequently, although Clayton is named only as an appellant our decision with respect to the materiality of K-55-1 renders it necessary to treat him also as an appellee. Thus, as to him, as one who purchased stock between November 12, 1963 and April 9, 1964, we reverse the implicit dismissal of the complaint, find that he violated §78j(b) and Rule 10b-5, and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(8) As to Drake, as one who passed on information to tippees, we reverse the dismissal of the complaint and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(9) As to Coates, as one who on April 16th purchased stock and gave information on which his son-in-law broker and the broker's customers purchased shares, we reverse the dismissal of the complaint, find that he violated 15 U. S. C. §78j(b) and Rule 10b-5, and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(10) As to Texas Gulf Sulphur, we reverse the dismissal of the complaint and remand for a further determination by the district judge in the light of the approach taken in this opinion.

The occurrences out of which this litigation arose are not set forth hereafter in as detailed a manner as they are set out in the published opinion of the court below, but are stated sufficiently, we believe, for the exposition of the issues raised by the several appeals to us.

The Factual Setting

This action derives from the exploratory activities of TGS begun in 1957 on the Canadian Shield in eastern Canada. In March of 1959, aerial geophysical surveys were conducted over more than 15,000 square miles of this area by a group led by defendant Mollison, a mining engineer and a Vice President of TGS. The group included defendant Holyk, TGS's chief geologist, defendant Clayton, an electrical engineer and geophysicist, and defendant Darke, a geologist. These operations resulted in the detection of numerous anomalies, i.e., extraordinary variations in the conductivity of rocks, one of which was on the Kidd 55 segment of land located near Timmins, Ontario.

On October 29 and 30, 1963, Clayton conducted a ground geophysical survey on the northeast portion of the Kidd 55 segment which confirmed the presence of an anomaly and indicated the necessity of diamond core drilling for further evaluation. Drilling of the initial hole, K-55-1, at the strongest part of the anomaly was commenced on November 8 and terminated on November 12 at a depth of 655 feet. Visual estimates by Holyk of the core of K-55-1 indicated an average copper content of 1.15% and an average zinc content of 8.64% over a length of 599 feet. This visual estimate convinced TGS that it was desirable to acquire the remainder of the Kidd 55 segment, and in order to facilitate this acquisition TGS President Stephens instructed the exploration group to keep the results of K-55-1 confidential and undisclosed even as to other officers, directors, and employees of TGS. The hole was concealed and a barren core was intentionally drilled off the anomaly. Meanwhile, the core of K-55-1 had been shipped to Utah for chemical assay which, when received in early December, revealed an average mineral content of 1.18% copper, 8.26%

zinc, and 3.94% ounces of silver per ton over a length of 602 feet. These results were so remarkable that neither Clayton, an experienced geophysicist, nor four other TGS expert witnesses, had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit. So, the trial court concluded, "There is no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it." *Id.* at 282. By March 27, 1964, TGS decided that the land acquisition program had advanced to such a point that the company might well resume drilling, and drilling was resumed on March 31.

During this period, from November 12, 1963 when K-55-1 was completed, to March 31, 1964 when drilling was resumed, certain of the individual defendants listed in fn. 2, *supra,* and persons listed in fn. 4, *supra,* said to have received "tips" from them, purchased TGS stock or calls thereon. Prior to these transactions these persons had owned 1135 shares of TGS stock and possessed no calls; thereafter they owned a total of 8235 shares and possessed 12,300 calls.

On February 20, 1964, also during this period, TGS issued stock options to 26 of its officers and employees whose salaries exceeded a specified amount, five of whom were the individual defendants Stephens, Fogarty, Mollison, Holyk, and Kline. Of these, only Kline was unaware of the detailed results of K-55-1, but he, too, knew that a hole containing favorable bodies of copper and zinc ore had been drilled in Timmins. At this time, neither the TGS Stock Option Committee nor its Board of Directors had been informed of the results of K-55-1, presumably because of the pending land acquisition program which required confidentiality. All of the foregoing defendants accepted the options granted them.

When drilling was resumed on March 31, hole K-55-3 was commenced 510 feet west of K-55-1 and was drilled easterly at a 45° angle so as to cross K-55-1 in a vertical plane. Daily progress reports of the drilling of this hole K-55-3 and of all subsequently drilled holes were sent to defendants Stephens and Fogarty (President and Executive Vice President of TGS) by Holyk and Mollison. Visual estimates of K-55-3 revealed an average mineral content of 1.12% copper and 7.93% zinc over 641 of the hole's 876-foot length. On April 7, drilling of a third hole, K-55-4, 200 feet south of and parallel to K-55-1 and westerly at a 45° angle, was commenced and mineralization was encountered over 366 of its 579-foot length. Visual estimates indicated an average content of 1.14% copper and 8.24% zinc. Like K-55-1, both K-55-3 and K-55-4 established substantial copper mineralization on the eastern edge of the anomaly. On the basis of these findings relative to the foregoing drilling results, the trial court concluded that the vertical plane created by the intersection of K-55-1 and K-55-3, which measured at least 350 feet wide by 500 feet deep extended southward 200 feet to its intersection with K-55-4, and that "There was real evidence that a body of commercially mineable ore might exist." *Id.* at 281-82.

On April 8 TGS began with a second drill rig to drill another hole, K-55-6, 300 feet easterly of K-55-1. This hole was drilled westerly at an angle of 60° and was intended to explore mineralization beneath K-55-1. While no visual estimates of its core were immediately available, it was readily apparent by the evening of April 10 that substantial copper mineralization had been encountered over the last 127 feet of the hole's 569-foot length. On April 10, a third drill rig commenced drilling yet another hole, K-55-5, 200 feet north of K-55-1, parallel to the prior

holes, and slanted westerly at a 45° angle. By the evening of April 10 in this hole, too, substantial copper mineralization had been encountered over the last 42 feet of its 97-foot length.

Meanwhile, rumors that a major ore strike was in the making had been circulating throughout Canada. On the morning of Saturday, April 11, Stephens at his home in Greenwich, Conn. read in the New York Herald Tribune and in the New York Times unauthorized reports of the TGS drilling which seemed to infer a rich strike from the fact that the drill cores had been flown to the United States for chemical assay. Stephens immediately contacted Fogarty at his home in Rye, N. Y., who in turn telephoned and later that day visited Mollison at Mollison's home in Greenwich to obtain a current report and evaluation of the drilling progress.[7] The following morning, Sunday, Fogarty again telephoned Mollison, inquiring whether Mollison had any further information and told him to return to Timmins with Holyk, the TGS Chief Geologist, as soon as possible "to move things along." With the aid of one Carroll, a public relations consultant, Fogarty drafted a press release designed to quell the rumors, which release, after having been channeled through Stephens and Huntington, a TGS attorney, was issued at 3:00 P.M. on Sunday, April 12, and which appeared in the morning newspapers of general circulation on Monday, April 13. It read in pertinent part as follows:

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7 Mollison had returned to the United States for the weekend. Friday morning, April 10, he had been on the Kidd tract "and had been advised by defendant Holyk as to the drilling results to 7:00 p.m. on April 10. At that time drill holes K-55-1, K-55-3 and K-55-4 had been completed; drilling of K-55-5 had started on Section 2200 S and had been drilled to 97 feet, encountering mineralization on the last 42 feet; and drilling of K-55-6 had been started on Section 2400 S and had been drilled to 569 feet, encountering mineralization over the last 127 feet." *Id.* at 294.

NEW YORK, April 12—The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:

"During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.

"The facts are as follows. TGS has been exploring in the Timmins area for six years as part of its overall search in Canada and elsewhere for various minerals—lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.

"Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.

"Recent drilling on one property near Timmins has led to preliminary indications that more drilling would

be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

"The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

* * * * *

The release purported to give the Timmins drilling results as of the release date, April 12. From Mollison Fogarty had been told of the developments through 7:00 P.M. on April 10, and of the remarkable discoveries made up to that time, detailed *supra,* which discoveries, according to the calculations of the experts who testified for the SEC at the hearing, demonstrated that TGS had already discovered 6.2 to 8.3 million tons of proven ore having gross assay values from $26 to $29 per ton. TGS experts, on the other hand, denied at the hearing that proven or probable ore could have been calculated on April 11 or 12 because there was then no assurance of continuity in the mineralized zone.

The evidence as to the effect of this release on the investing public was equivocal and less than abundant. On April 13 the New York Herald Tribune in an article head-noted "Copper Rumor Deflated" quoted from the TGS release of April 12 and backtracked from its original April 11 report

of a major strike but nevertheless inferred from the TGS release that "recent mineral exploratory activity near Timmins, Ontario, has provided preliminary favorable results, sufficient at least to require a step-up in drilling operations." Some witnesses who testified at the hearing stated that they found the release encouraging. On the other hand, a Canadian mining security specialist, Roche, stated that "earlier in the week [before April 16] we had a Dow Jones saying that they [TGS] didn't have anything basically" and a TGS stock specialist for the Midwest Stock Exchange became concerned about his long position in the stock after reading the release. The trial court stated only that "While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known." *Id.* at 296.

Meanwhile, drilling operations continued. By the morning of April 13, in K-55-5, the fifth drill hole, substantial copper mineralization had been encountered to the 580 foot mark, and the hole was subsequently drilled to a length of 757 feet without further results. Visual estimates revealed an average content of 0.82% copper and 4.2% zinc over a 525-foot section. Also by 7:00 A.M. on April 13, K-55-6 had found mineralization to the 946-foot mark. On April 12 a fourth drill rig began to drill K-55-7, which was drilled westerly at a 45° angle, at the eastern edge of the anomaly. The next morning the 137 foot mark had been reached, fifty feet of which showed mineralization. By 7:00 P.M. on April 15, the hole had been completed to a length of 707 feet but had only encountered additional mineralization during a 26-foot length between the 425 and 451-foot marks. A mill test hole, K-55-8, had been drilled and was complete by the evening of April 13 but its mineralization had not been reported upon prior to April

16. K-55-10 was drilled westerly at a 45° angle commencing April 14 and had encountered mineralization over 231 of its 249-foot length by the evening of April 15. It, too, was drilled at the anomaly's eastern edge.

While drilling activity ensued to completion, TGS officials were taking steps toward ultimate disclosure of the discovery. On April 13, a previously-invited reporter for The Northern Miner, a Canadian mining industry journal, visited the drillsite, interviewed Mollison, Holyk and Darke, and prepared an article which confirmed a 10 million ton ore strike. This report, after having been submitted to Mollison and returned to the reporter unamended on April 15, was published in the April 16 issue. A statement relative to the extent of the discovery, in substantial part drafted by Mollison, was given to the Ontario Minister of Mines for release to the Canadian media. Mollison and Holyk expected it to be released over the airways at 11 P.M. on April 15th, but, for undisclosed reasons, it was not released until 9:40 A.M. on the 16th. An official detailed statement, announcing a strike of at least 25 million tons of ore, based on the drilling data set forth above, was read to representatives of American financial media from 10:00 A.M. to 10:10 or 10:15 A.M. on April 16, and appeared over Merrill Lynch's private wire at 10:29 A.M. and, somewhat later than expected, over the Dow Jones ticker tape at 10:54 A.M.

Between the time the first press release was issued on April 12 and the dissemination of the TGS official announcement on the morning of April 16, the only defendants before us on appeal who engaged in market activity were Clayton and Crawford and TGS director Coates. Clayton ordered 200 shares of TGS stock through his Canadian

broker on April 15 and the order was executed that day over the Midwest Stock Exchange. Crawford ordered 300 shares at midnight on the 15th and another 300 shares at 8:30 A.M. the next day, and these orders were executed over the Midwest Exchange in Chicago at its opening on April 16. Coates left the TGS press conference and called his broker son-in-law Haemisegger shortly before 10:20 A.M. on the 16th and ordered 2,000 shares of TGS for family trust accounts of which Coates was a trustee but not a beneficiary; Haemisegger executed this order over the New York and Midwest Exchanges, and he and his customers purchased 1500 additional shares.

During the period of drilling in Timmins, the market price of TGS stock fluctuated but steadily gained overall. On Friday, November 8, when the drilling began, the stock closed at 17⅜; on Friday, November 15, after K-55-1 had been completed, it closed at 18. After a slight decline to 16⅜ by Friday, November 22, the price rose to 20⅞ by December 13, when the chemical assay results of K-55-1 were received, and closed at a high of 24⅛ on February 21, the day after the stock options had been issued. It had reached a price of 26 by March 31, after the land acquisition program had been completed and drilling had been resumed, and continued to ascend to 30⅛ by the close of trading on April 10, at which time the drilling progress up to then was evaluated for the April 12th press release. On April 13, the day on which the April 12 release was disseminated, TGS opened at 30⅛, rose immediately to a high of 32 and gradually tapered off to close at 30⅞. It closed at 30¼ the next day, and at 29⅜ on April 15. On April 16, the day of the official announcement of the Timmins discovery, the price climbed to a high of 37 and closed at 36⅜. By May 15, TGS stock was selling at 58¼.

I. The Individual Defendants

A. *Introductory*

Rule 10b-5, 17 CFR 240.10b-5, on which this action is predicated, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934 (15 U. S. C. 78j(b).[8]

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8 15 U. S. C. §78j reads in pertinent part as follows:

> §78j. Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device

By that Act Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges, see 3 Loss, Securities Regulation 1455-56 (2d ed. 1961). The Act and the Rule apply to the transactions here, all of which were consummated on exchanges. See *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 461-62 (2 Cir.), *cert. denied*, 382 U. S. 811 (1965); *Cochran* v. *Channing Corp.*, 211 F. Supp. 239, 243 (SDNY 1962). Whether predicated on traditional fiduciary concepts, see, e.g., *Hotchkiss* v. *Fisher*, 16 P. 2d 531 (Kan. 1932), or on the "special facts" doctrine, see, e.g., *Strong* v. *Repide*, 213 U. S. 419 (1909), the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information, see Cary, Insider Trading in Stocks, 21 Bus. Law. 1009, 1010 (1966), Fleischer, Securities Trading and Corporation Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1278-80 (1965). The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. *Matter of Cady, Roberts & Co.*, 40 SEC 907, 912 (1961). Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one

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or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the Act. *Cady, Roberts, supra.* Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material,[9] its possessors should have kept out of the market until disclosure was accomplished. *Cady, Roberts, supra* at 911.

B. *Material Inside Information*

An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in "those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed." Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1289.

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9 Congress intended by the Exchange Act to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office. See Sections 2 and 16 of the Act; H. R. Rep. No. 1383, 73rd Cong., 2d Sess. 13 (1934); S. Rep. No. 792, 73rd Cong., 2d Sess. 9 (1934); S. E. C., Tenth Annual Report 50 (1944). See *Cady, Roberts, supra* at 912.

Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions. 3 Loss, *op. cit. supra* at 1463. The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

This is not to suggest, however, as did the trial court, that "the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight," 258 F. Supp. 262 at 280, in the sense that the materiality of facts is to be assessed solely by measuring the effect the knowledge of the facts would have upon prudent or conservative investors. As we stated in *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462, "The basic test of materiality . . . is whether a *reasonable* man would attach importance . . . in determining his choice of action in the transaction in question. Restatement, Torts §538(2)(a); accord Prosser, Torts 554-55; I Harper & James, Torts 565-66." (Emphasis supplied.) This, of course, encompasses any fact ". . . which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities. . . ." *List* v. *Fashion Park, Inc., supra* at 462, quoting from *Kohler* v. *Kohler Co.*, 319 F. 2d 634, 642 (7 Cir. 1963). (Emphasis supplied.) Such a fact is a material fact and must be effectively disclosed to the investing public prior to the commencement of insider trading in the corporation's securities. The speculators and chartists of Wall and Bay Streets are also "reasonable" investors entitled to the same

legal protection afforded conservative traders.[10] Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.

In each case, then, whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. Here, notwithstanding the trial court's conclusion that the results of the first drill core, K-55-1, were "too 'remote' . . . to have had any significant impact on the market, i.e., to be deemed material,"[11] 258 F. Supp. at 283, knowledge of the possibility, which surely was

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10 The House of Representatives committee that reported out the bill which eventually became the Act did so with the observation that "no investor, *no speculator*, can safely buy and sell securities upon exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." H. R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 11. (Emphasis supplied.)

Dr. Bellemore, the Texas Gulf defendants' expert witness, has written: "The intelligent speculator assumes that facts are available for a thorough analysis. The speculator then examines the facts to discover and evaluate the risks that are present. He then balances these risks against the apparent opportunities for capital gains and makes his decision accordingly. He is, to the best of his ability, taking calculated risks." Bellemore, Investments: Principles, Practices and Analysis 4 (2d ed. 1962).

11 We are not, of course, bound by the trial court's determination as to materiality unless we find it "clearly erroneous" for that standard of appellate review is applicable only to issues of basic fact and not to issues of ultimate fact. See *Baranow* v. *Gibraltar Factors Corp.*, 366 F. 2d 584, 587 (2 Cir. 1966); *Mamiye Bros.* v. *Barber S.S. Lines, Inc.*, 360 F. 2d 774, 776-78 (2 Cir.), cert. denied, 385 U. S. 835 (1966); see also *SEC* v. *R. A. Holman & Co.*, 366 F. 2d 456, 457-58 (2 Cir. 1966) (by implication).

more than marginal, of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface (suggesting mineability by the less expensive open-pit method) within the confines of a large anomaly (suggesting an extensive region of mineralization) might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold. After all, this first drill core was "unusually good and . . . excited the interest and speculation of those who knew about it." 258 F. Supp. at 282.

Our disagreement with the district judge on this issue does not, then, go to his findings of basic fact, as to which the "clearly erroneous" rule would apply, but to his understanding of the legal standard applicable to them. See *In re Hygrade Envelope Corp.*, 366 F. 2d 584, 587-89 (2 Cir. 1966), and cases cited in footnote 11 *supra*. Our survey of the facts found below conclusively establishes that knowledge of the results of the discovery hole, K-55-1, would have been important to a reasonable investor and might have affected the price of the stock.[12] On April 16, *The Northern Miner*, a trade publication in wide circulation among mining stock specialists, called K-55-1, the discovery hole, "one of the most impressive drill holes completed in

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12 We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC. Here, a valuable corporate purpose was served by delaying the publication of the K-55-1 discovery. We do intend to convey, however, that where a corporate purpose is thus served by withholding the news of a material fact, those persons who are thus quite properly true to their corporate trust must not during the period of non-disclosure deal personally in the corporation's securities or give to outsiders confidential information not generally available to all the corporations' stockholders and to the public at large.

modern times."[13] Roche, a Canadian broker whose firm specialized in mining securities, characterized the importance to investors of the results of K-55-1. He stated that the completion of "the first drill hole" with "a 600 foot drill core is very very significant . . . anything over 200 feet is considered very significant and 600 feet is just beyond your wildest imagination." He added, however, that it "is a natural thing to buy more stock once they give you the first drill hole." Additional testimony revealed that the prices of stocks of other companies, albeit less

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13 The April 16th article in The Northern Miner resulted from the reporter's April 13th visit to the drill site where he interviewed defendants Mollison, Holyk and Darke and looked at records of the drilling to that time. The text of the article was approved by Mollison in Timmins on April 15th. The first five paragraphs read as follows:

Should Make Substantial Open Pit Operation

TEXAS GULF SULPHUR COMES UP WITH A "MAJOR"

See Big Tonnages Of Base Metals, Plus Silver

Texas Gulf Sulphur has chalked up a brilliant exploration success in its field program north of the Porcupine area. Following a visit to the discovery property, The Northern Miner can say that a major new zinc-copper-silver mine is definitely in the making, one that has all the earmarks of shaping into a substantial open pit operation.

Only a relative handful of holes has been completed since the discovery hole but on the basis of seven tests either completed or drilling it can be stated that a strike length of 600 ft. minimum has been established, showing an ore width of roughly 300 ft. which has been traced so far to a maximum vertical depth of about 800 ft.

So recent has been the discovery, and so urgent the effort to accelerate the drill program (four machines have been moved in since the discovery hole was completed), that assays have been completed on only the discovery. But this must be recorded as one of the most impressive drill holes completed in modern times.

For a core length of a shade better than 600 ft., the hole averaged in excess of 1% copper, 8% zinc and nearly four ounces of silver.

And there are impressive, strong sections within this width which in themselves are quite spectacular. In the upper part of the hole, for example, a core length of 82 ft. ran 7.1% copper, 9.7% zinc and 2.4 ozs. silver. This was followed by continuous values of ore tenor—deeper down, a 100-ft. section runs 0.33% copper, 0.8% lead, 14.3% zinc and 4.2 ozs. silver. And still deeper, a strong zinc section of better than 100 ft. averaged out to in excess of seven ounces of silver in addition to ore-grade zinc values.

diversified, smaller firms, had increased substantially solely on the basis of the discovery of good anomalies or even because of the proximity of their lands to the situs of a potentially major strike.

Finally, a major factor in determining whether the K-55-1 Discovery was a material fact is the importance attached to the drilling results by those who knew about it. In view of other unrelated recent developments favorably affecting TGS, participation by an informed person in a regular stock-purchase program, or even sporadic trading by an informed person, might lend only nominal support to the inference of the materiality of the K-55-1 discovery; nevertheless, the timing by those who knew of it of their stock purchases and their purchases of *short-term* calls—purchases in some cases by individuals who had never before purchased calls or even TGS stock—virtually compels the inference that the insiders were influenced by the drilling results. This insider trading activity, which surely constitutes highly pertinent evidence and the only truly objective evidence of the materiality of the K-55-1 discovery, was apparently disregarded by the court below in favor of the testimony of defendants' expert witnesses, all of whom "agreed that one drill core does not establish an ore body, much less a mine," 258 F. Supp. at 282-283. Significantly, however, the court below, while relying upon what these defense experts said the defendant insiders *ought* to have thought about the worth to TGS of the K-55-1 discovery, and finding that from November 12, 1963 to April 6, 1964 Fogarty, Murray, Holyk and Darke spent more than $100,000 in purchasing TGS stock and calls on that stock, made no finding that the insiders were motivated by any factor other than the extraordinary K-55-1 discovery when they bought their stock and their calls. No reason appears why outside investors, perhaps better acquainted with spec-

ulative modes of investment and with, in many cases, perhaps more capital at their disposal for intelligent speculation, would have been less influenced, and would not have been similarly motivated to invest if they had known what the insider investors knew about the K-55-1 discovery.

Our decision to expand the limited protection afforded outside investors by the trial court's narrow definition of materiality is not at all shaken by fears that the elimination of insider trading benefits will deplete the ranks of capable corporate managers by taking away an incentive to accept such employment. Such benefits, in essence, are forms of secret corporate compensation, see Cary, Corporate Standards and Legal Rules, 50 Calif. L. Rev. 408, 409-10 (1962), derived at the expense of the uninformed investing public and not at the expense of the corporation which receives the sole benefit from insider incentives. Moreover, adequate incentives for corporate officers may be provided by properly administered stock options and employee purchase plans of which there are many in existence. In any event, the normal motivation induced by stock ownership, i.e., the identification of an individual with corporate progress, is ill-promoted by condoning the sort of speculative insider activity which occurred here; for example, some of the corporation's stock was sold at market in order to purchase short-term calls upon that stock, calls which would never be exercised to increase a stockholder equity in TGS unless the market price of that stock rose sharply.

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,—which market risks include, of course the risk that one's evaluative capacity or one's capital available to put

at risk may exceed another's capacity or capital. The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event such a major strike should materialize, but would decline little, if at all, in the event of failure, for the public, ignorant at the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.

We hold, therefore, that all transactions in TGS stock or calls by individuals apprised of the drilling results[14] of K-55-1 were made in violation of Rule 10b-5.[15] Inasmuch as the visual evaluation of that drill core (a generally reliable estimate though less accurate than a chemical assay) constituted material information, those advised of the results of the visual evaluation as well as those informed of the chemical assay traded in violation of law. The geologist Darke possessed undisclosed material information and

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14 The trial court found that defendant Murray "had no detailed knowledge as to the work" on the Kidd-55 segment. There is no evidence in the record suggesting that Murray purchased his stock on January 8, 1964, on the basis of material undisclosed information, and the disposition below is undisturbed as to him.

15 Even if insiders were in fact ignorant of the broad scope of the Rule and acted pursuant to a mistaken belief as to the applicable law such an ignorance does not insulate them from the consequences of their acts. *Yager* v. *SEC*, 344 F. 2d 5, 8 (2 Cir. 1965).

traded in TGS securities. Therefore we reverse the dismissal of the action as to him and his personal transactions. The trial court also found, 258 F. Supp. at 284, that Darke, after the drilling of K-55-1 had been completed and with detailed knowledge of the results thereof, told certain outside individuals that TGS "was a good buy." These individuals thereafter acquired TGS stock and calls. The trial court also found that later, as of March 30, 1964, Darke not only used his material knowledge for his own purchases but that the substantial amounts of TGS stock and calls purchased by these outside individuals on that day, see footnote 4, *supra*, was "strong circumstantial evidence that Darke must have passed the word to one or more of his 'tippees' that drilling on the Kidd 55 segment was about to be resumed." 258 F. Supp. at 284. Obviously if such a resumption were to have any meaning to such "tippees," they must have previously been told of K-55-1.

Unfortunately, however, there was no definitive resolution below of Darke's liability in these premises for the trial court held as to him, as it held as to all the other individual defendants, that this "undisclosed information" never became material until April 9. As it is our holding that the information acquired after the drilling of K-55-1 was material, we, on the basis of the findings of direct and circumstantial evidence on the issue that the trial court has already expressed, hold that Darke violated Rule 10b-5(3) and Section 10(b) by "tipping" and we remand, pursuant to the agreement of the parties, for a determination of the appropriate remedy.[16] As Darke's "tippees" are not defen-

16 Judges Waterman and Anderson, believing that there had been no definitive finding below as to whether Darke, expressly or by implication, transmitted to these outsiders any indication of the extremely favorable results of the drilling operation in which he was engaged, would remand

dants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible.

With reference to Huntington, the trial court found that he "had no detailed knowledge as to the work" on the Kidd-55 segment, 258 F. Supp. 281. Nevertheless, the evidence shows that he knew about and participated in TGS's land acquisition program which followed the receipt of the K-55-1 drilling results, and that on February 26, 1964 he purchased 50 shares of TGS stock. Later, on March 16, he helped prepare a letter for Dr. Holyk's signature in which TGS made a substantial offer for lands near K-55-1, and on the same day he, who had never before purchased calls on any stock, purchased a call on 100 shares of TGS stock. We are satisfied that these purchases in February and March, coupled with his readily inferable and probably reliable, understanding of the highly favorable nature of preliminary operations on the Kidd segment, demonstrate that Huntington possessed material inside information such as to make his purchase violative of the Rule and the Act.

C. *When May Insiders Act?*

Appellant Crawford, who ordered[17] the purchase of TGS stock shortly before the TGS April 16 official announce-

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for a determination on this issue, and if it should be determined that Darke did make such revelations, for a determination of the appropriate remedy.

17 The effective protection of the public from insider exploitation of advance notice of material information requires that the time that an insider places an order, rather than the time of its ultimate execution, be determinative for Rule 10b-5 purposes. Otherwise, insiders would

ment, and defendant Coates, who placed orders with and communicated the news to his broker immediately after the official announcement was read at the TGS-called press conference, concede that they were in possession of material information. They contend, however, that their purchases were not proscribed purchases for the news had already been effectively disclosed. We disagree.

Crawford telephoned his orders to his Chicago broker about midnight on April 15 and again at 8:30 in the morning of the 16th, with instructions to buy at the opening of the Midwest Stock Exchange that morning. The trial court's finding that "he sought to, and did, 'beat the news,'" 258 F. Supp. at 287, is well documented by the record. The rumors of a major ore strike which had been circulated in Canada and, to a lesser extent, in New York, had been disclaimed by the TGS press release of April 12, which significantly promised the public an official detailed announcement when possibilities had ripened into actualities. The abbreviated announcement to the Canadian press at 9:40 A.M. on the 16th by the Canadian Minister of Mines and the report carried by *The Northern Miner,* parts of which had sporadically reached New York on the morning of the 16th through reports from Canadian affiliates to a few New York investment firms, are assuredly not the equivalent of the official 10-15 minute announcement which was not released to the American financial press until after 10:00 A.M. Crawford's orders had been placed before that. Be-

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be able to "beat the news," cf. Fleischer, *supra,* 51 Va. L. Rev. at 1291, by requesting in advance that their orders be executed immediately after the dissemination of a major news release but before outsiders could act on the release. Thus it is immaterial whether Crawford's orders were executed before or after the announcement was made in Canada (9:40 A.M., April 16) or in the United States (10:00 A.M.) or whether Coates's order was executed before or after the news appeared over the Merrill Lynch (10:29 A.M.) or Dow Jones (10:54 A.M.) wires.

fore insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public. Particularly here, where a formal announcement to the entire financial news media had been promised in a prior official release known to the media, all insider activity must await dissemination of the promised official announcement.

Coates was absolved by the court below because his telephone order was placed shortly before 10:20 A.M. on April 16, which was after the announcement had been made even though the news could not be considered already a matter of public information. 258 F. Supp. at 288. This result seems to have been predicated upon a misinterpretation of dicta in *Cady, Roberts,* where the SEC instructed insiders to "keep out of the market until the established procedures for public release of the information are *carried out* instead of hastening to execute transactions in advance of, and in frustration of, the objectives of the release," 40 SEC at 915 (emphasis supplied). The reading of a news release, which prompted Coates into action, is merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments. Assuming that the contents of the official release could instantaneously be acted upon,[18] at the minimum

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18 Although the only insider who acted after the news appeared over the Dow Jones broad tape is not an appellant and therefore we need not discuss the necessity of considering the advisability of a "reasonable waiting period" during which outsiders may absorb and evaluate disclosures, we note in passing that, where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination. In any event, the permissible timing of insider transactions after disclosures of various sorts is one of the many areas of expertise for appropriate exercise of the SEC's rule-making power, which we hope will be utilized in the future to provide some predictability of certainty for the business community.

Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law.[19]

D. *Is An Insider's Good Faith A Defense Under 10b-5?*

Coates, Crawford and Clayton, who ordered purchases before the news could be deemed disclosed, claim, nevertheless, that they were justified in doing so because they honestly believed that the news of the strike had become public at the time they placed their orders. However, whether the case before us is treated solely as an SEC enforcement proceeding or as a private action,[20] proof of a specific intent to defraud is unnecessary. In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful. See *Berko* v. *SEC*, 316 F. 2d 137, 141-42 (2 Cir.

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19 The record reveals that news usually appears on the Dow Jones broad tape 2-3 minutes after the reporter completes dictation. Here, assuming that the Dow Jones reporter left the press conference as early as possible, 10:10 A.M., the 10-15 minute release (which took at least that long to dictate) could not have appeared on the wire before 10:22, and for other reasons unknown to us did not appear until 10:54. Indeed, even the abbreviated version of the release reported by Merrill Lynch over its private wire did not appear until 10:29. Coates, however, placed his call no later than 10:20.

20 The SEC seeks permanent injunctions restraining future proscribed activity by all the individual defendants and the corporation. The Commission also seeks court orders upon certain of the individual defendants that are essentially remedies of a private, rather than of a regulatory nature, court orders designed to have those individual defendants disgorge any profits they enjoyed from TGS stock transactions they or their "tippees" engaged in from November 12, 1963 to April 17, 1964.

1963); *SEC* v. *Capital Gains Bureau,* 375 U. S. 180, 193 (1963). A similar standard has been adopted in private actions, see, *e.g., Stevens* v. *Vowell,* 343 F. 2d 374 (10 Cir. 1965); *Ellis v. Carter,* 291 F. 2d 270 (9 Cir. 1961); *Royal Air Properties, Inc.* v. *Smith,* 312 F. 2d 210 (9 Cir. 1962); *Dack* v. *Shanman,* 227 F. Supp. 26 (SDNY 1964); but see, *e.g., Weber* v. *C. M. P. Corp.,* 242 F. Supp. 321 (SDNY 1965); *Thiele* v. *Shields,* 131 F. Supp. 416 (SDNY 1955), for policy reasons which seem perfectly consistent with the broad Congressional design ". . . to insure the maintenance of fair and honest markets in . . . [securities] transactions." Sec. 2 of SEC Act, 15 U. S. C. §78b, see *Kohler* v. *Kohler Co.,* 319 F. 2d 634, 642 (7 Cir. 1963); Note, 32 U. Chi. L. Rev. 824, 839-44 (1965); Note, 63 Mich. L. Rev. 1070, 1079-81 (1965).

Absent any clear indication of a legislative intention to require a showing of specific fraudulent intent, see Note, 63 Mich. L. Rev. 1070, 1075, 1076 n. 29 (1965), the securities laws should be interpreted as an expansion of the common law[21] both to effectuate the broad remedial design of Congress, see *SEC* v. *Capital Gains Research Bureau, supra* at 195, and to insure uniformity of enforcement, see Note, 32 U. Chi. L. Rev. 824, 832 n. 36 (1965), citing *McClure* v. *Borne Chemical Co.,* 292 F. 2d 824, 834 (3 Cir. 1961). Moreover, a review of other sections of the Act from which Rule 10b-5 seems to have been drawn suggests that the implementation of a standard of conduct that encompasses

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21 Even at common law, the essentially private remedy of rescission which is sought here does not require more than a showing of negligence and frequently even less than that, see Restatement, Contracts, §476, com b (1932); and the common law concept of constructive fraud still available to private plaintiffs, see *Trussell* v. *United Underwriters, Ltd.,* 228 F. Supp. 757, 772 (D. Colo. 1964), has been expanded from recklessness, see Prosser, Torts, §102 p. 715-17 (3d ed. 1964), to include non-reckless negligent misrepresentations or omissions, see Note, 63 Mich. L. Rev. 1070, 1079.

negligence as well as active fraud comports with the administrative and the legislative purposes underlying the Rule.[22] Finally, we note that this position is not, as asserted by defendants, irreconcilable with previous language in this circuit because *"some form* of the traditional scienter requirement," *Barnes* v. *Osofsky*, 373 F. 2d 269, 272 (2 Cir. 1967), (emphasis supplied), sometimes defined as "fraud," *Fischman* v. *Raytheon Mfg. Co.*, 9 F. R. D. 707 (SDNY 1949), *rev'd on other grounds*, 188 F. 2d 783, 786 (2 Cir. 1951) is preserved. This requirement, whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule.

Thus, the beliefs of Coates, Crawford and Clayton that the news of the ore strike was sufficiently public at the time of their purchase orders are to no avail if those beliefs were no reasonable under the circumstances. Crawford points to the scattered rumors of the discovery which had been circulating for some time before April 15, to the release of the information to *The Northern Miner* on April

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22 Liability under §12(2) of the Securities Act of 1933, 15 U. S. C. §77*l*(2), the language of which is strikingly similar to that of 10b-5(2), attaches from the mere fact of misrepresentation or misleading omission unless defendant proves that "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." The provisions of Sections 17(a)(2) and (3) of the Securities Act of 1933, 15 U. S. C. §77q(a)(2) and (3), which are virtually identical to the provisions of Rule 10b-5(2) and (3) and were, in fact, the model therefor, see *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461, 463 (2 Cir.), cert. denied, 343 U. S. 956 (1952); *Hooper* v. *Mountain States Sec. Corp.*, 282 F. 2d 195, 201 n. 4 (5 Cir. 1960), cert. denied, 365 U. S. 814 (1961), apply criminal penalties to sellers only (Rule 10b-5 was promulgated to fill this gap in enforcement, SEC Ann. Rep. 10 (1942)), and have been read, upon close scrutiny of their legislative history, as not requiring specific fraudulent intent, *SEC* v. *Van Horn*, 371 F. 2d 181, at 184-186 (7 Cir. 1966); *United States* v. *Schaefer*, 299 F. 2d 625, 629 (7 Cir. 1962) (lack of diligence is all that is required for conviction in a criminal prosecution for violation of §17(a) of the 1933 Act.

15 to be published by it on the 16th, to the arrangement made by TGS with the Ontario Minister of Mines for the release of an abbreviated report on the evening of the 15th (which did not eventuate until 9:40 A.M., April 16), and to the corporation's official announcement at 10:00 A.M. on the 16th, all of which transpired prior to an anticipated execution of his purchase orders that had been placed by him after trading had closed on the Midwest Exchange on April 15. However, the rumors and casual disclosure through Canadian media, especially in view of the April 12 gloomy or incomplete release denying the rumors and promising official confirmation, hardly sufficed to inform traders on American exchanges affected by Crawford's purchases. Moreover, the formal announcement could not reasonably have been expected to be disseminated by the time of the opening of the exchanges on the morning of April 16, when Crawford must have expected his orders would be executed.

Clayton, who was unaware of the April 16 disclosure announcement TGS was to make can, in support of his claim that the favorable news was public, rely only on the rumors and on the phone calls received by TGS prior to the placing of his order from those who seemed to have heard some version or rumors of the news. His awareness of the contents of the April 12 release renders unreasonable any claim that he believed the news was truly public.

Finally, Coates, as we have already indicated in fn. 19, *supra,* could not reasonably have expected the official release to have been disseminated when he placed his order before 10:20 for immediate execution nor were the Canadian disclosures relied on by Crawford sufficient to render the conduct of Coates permissible under the circumstances.[23]

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23 Coates's violations encompass not only his own purchases but also the purchases by his son-in-law and the customers of his son-in-law, to whom the material information was passed. See footnote 16, *supra.*

E. *May Insiders Accept Stock Options Without Disclosing Material Information To The Issuer?*

On February 20, 1964, defendants Stephens, Fogarty, Mollison, Holyk and Kline accepted stock options issued to them and a number of other top officers of TGS, although not one of them had informed the Stock Option Committee of the Board of Directors or the Board of the results of K-55-1, which information we have held was then material. The SEC sought rescission of these options. The trial court, in addition to finding the knowledge of the results of the K-55 discovery to be immaterial, held that Kline had no detailed knowledge of the drilling progress and that Holyk and Mollison could reasonably assume that their superiors, Stephens and Fogarty, who were directors of the corporation, would report the results if that was advisable; indeed all employees had been instructed not to divulge this information pending completion of the land acquisition program, 258 F. Supp. at 291. Therefore, the court below concluded that only directors Stephens and Fogarty, of the top management, would have violated the Rule by accepting stock options without disclosure, but it also found that they had not acted improperly as the information in their possession was not material. 258 F. Supp. at 292. In view of our conclusion as to materiality we hold that Stephens and Fogarty violated the Rule by accepting them. However, as they have surrendered the options and the corporation has canceled them, *supra* at 292, n. 17, we find it unnecessary to order that the injunctions prayed for be actually issued. We point out, nevertheless, that the surrender of these options after the SEC commenced the case is not a satisfaction of the SEC claim, and a determination as to whether the issuance of injunctions against Stephens and Fogarty is advisable in order to prevent or deter future violations of regulatory provi-

sions is remanded for the exercise of discretion by the trial court.

Contrary to the belief of the trial court that Kline had no duty to disclose his knowledge of the Kidd project before accepting the stock option offered him, we believe that he, a vice president, who had become the general counsel of TGS in January 1964, but who had been secretary of the corporation since January 1961, and was present in that capacity when the options were granted, and who was in charge of the mechanics of issuance and acceptance of the options, was a member of top management and under a duty before accepting his option to disclose any material information he may have possessed, and, as he did not disclose such information to the Option Committee we direct rescission of the option he received.[24] As to Holyk and

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24 The options granted on February 20, 1964 to Mollison, Holyk, and Kline were ratified by the Texas Gulf directors on July 15, 1965 after there had been, of course, a full disclosure and after this action had been commenced. However, the ratification is irrelevant here, for we would hold with the district court that a member of top management, as was Kline, is required, before accepting a stock option, to disclose material inside information which, if disclosed, might affect the price of the stock during the period when the accepted option could be exercised. Kline had known since November 1962 that K-55-1 had been drilled, that the drilling had intersected a sulphide body containing copper and zinc, and that TGS desired to acquire adjacent property.

Of course, if any of the five knowledgeable defendants had rejected his option there might well have been speculation as to the reason for the rejection. Therefore, in a case where disclosure to the grantors of an option would seriously jeopardize a corporate security, it could well be desirable, in order to protect a corporation from selling securities to insiders who are in a position to appreciate their true worth at a price which may not accurately reflect the true value of the securities and at the same time to preserve when necessary the secrecy of corporate activity, not to require that an insider possessed of undisclosed material information reject the offer of a stock option, but only to require that he abstain from exercising it until such time as there shall have been a full disclosure and, after the full disclosure, a ratification such as was voted here. However, as this suggestion was not presented to us, we do not consider it or make any determination with reference to it.

Mollison, the SEC has not appealed the holding below that they, not being then members of top management (although Mollison was a vice president) had no duty to disclose their knowledge of the drilling before accepting their options. Therefore, the issue of whether, by accepting, they violated the Act, is not before us, and the holding below is undisturbed.

II. The Corporate Defendant

Introductory

At 3:00 P.M. on April 12, 1964, evidently believing it desirable to comment upon the rumors concerning the Timmins project, TGS issued the press release quoted in pertinent part in the text at pages 3600-3601, *supra*. The SEC argued below and maintains on this appeal that this release painted a misleading and deceptive picture of the drilling progress at the time of its issuance, and hence violated Rule 10b-5(2).[25] TGS relies on the holding of the court below that "The issuance of the release produced no unusual market action" and "In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or Rule 10b-5 since it was not issued 'in connection with the purchase or sale of any security'" and, alternatively, "even if it had been established that the April 12 release was issued in connec-

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25 Rule 10b-5(2) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, . . .
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, . . .
>
> in connection with the purchase or sale of any security.

tion with the purchase or sale of any security, the Commission has failed to demonstrate that it was false, misleading or deceptive." 258 F. Supp. at 294.

Before further discussing this matter it seems desirable to state exactly what the SEC claimed in its complaint and what it seeks. The specific SEC allegation in its complaint is that this April 12 press release ". . . was materially false and misleading and was known by certain of defendant Texas Gulf's officers and employees, including defendants Fogarty, Mollison, Holyk, Darke and Clayton, to be materially false and misleading."

The specific relief the SEC seeks is, pursuant to Section 21(e) of Securities Exchange Act of 1934, 15 U. S. C. §78u(e), a permanent injunction restraining the issuance of any further materially false and misleading publicly distributed informative items.[26]

B. *The "In Connection With . . ." Requirement.*

In adjudicating upon the relationship of this phrase to the case before us it would appear that the court below used a standard that does not reflect the congressional purpose that prompted the passage of the Securities Exchange Act of 1934.

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26 The prayer for relief reads:

WHEREFORE the plaintiff prays for:

* * * * *

(5) The issuance of a final judgment permanently enjoining the defendant Texas Gulf from directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, in connection with the purchase or sale of securities, making any untrue statement of material fact or omitting to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, namely, from issuing, publishing, distributing or otherwise disseminating materially false, misleading, inadequate or inaccurate press releases and other communications and reports concerning material facts about Texas Gulf's activities and operations.

The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading, including, specifically, inequities that follow from trading that has been stimulated by the publication of false or misleading corporate information releases. Commenting on the disclosure purposes of the House bill (H. R. 9323), the bill a Committee of Conference eventually integrated with a similar Senate bill (S. 3420) to make the bill passed by both Houses of Congress that became the Securities Exchange Act of 1934, the House Committee which reported out H. R. 9323 stated:

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. *There cannot be honest markets without honest publicity.* Manipulation and dishonest practices of the market place thrive upon mys[illegible]ry and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug

> of conflicting interests and the influence of popular groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of *true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges.* Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet. (Emphasis supplied.) H. R. Rep. No. 1383, 73rd Cong., 2d Sess. 11 (1934).

Section 10b of the Act (see footnote 8, *supra*) was taken by the Conference Committee from Section 10b of the proposed Senate bill, S. 3420, and taken from it verbatim insofar as here pertinent. The only alteration made by the Conference Committee was to substitute the present closing language of Section 10b, "... in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors" for the closing language of the original Section 10b of S. 3420, "... which the Commission may declare to be detrimental to the interests of investors." 78 Cong. Rec. 10261 (1934).

The Report of the Senate Committee which presented S. 3420 to the Senate summarized Section 10b as follows:

> Subsection (b) authorizes the Commission by rules and regulations to prohibit or regulate the use of *any other manipulative or deceptive practices which it finds detrimental to the interests of the investor.* (Emphasis supplied.)
>
> S. Rep. No. 792, 73rd Cong., 2d Sess. 18 (1934).

Indeed, from its very inception, Section 10(b), and the proposed sections in H. R. 1383 and S. 3420 from which it was derived, have always been acknowledged as catch-alls. See Bromberg, Securities Law: SEC Rule 10b-5, p. 19 (1967). In the House Committee hearings on the proposed House bill, Thomas G. Corcoran, Counsel with the Reconstruction Finance Corporation and a spokesman for the Roosevelt Administration, described the broad prohibitions contained in §9(c), the section which corresponded to Section 10(b) of S. 3420 and eventually to Section 10(b) of the Act, as follows: "Subsection (c) says, 'Thou shalt not devise any other cunning devices' . . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices." Stock Exchange Regulation, Hearings before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 2d Sess. 115 (1934). Although several other witnesses objected to the breadth of the proposed prohibition that Corcoran was supporting, the section as enacted did not in any way limit the broad scope of the "in connection with" phrase. See 3 Loss, Securities Regulation, 1424 n. 7 (2d ed. 1961).

Thus, the legislative history of Section 10(b) does not support the proposition urged upon us by Texas Gulf Sulphur that Congress intended the limited construction of the "in connection with" phrase applied by the trial court.

Moreover, comparisons of Section 10(b) with the antifraud provisions of the Securities Act of 1933 (§12(2), 15 U. S. C. §77*l*(2) "... [offers or] sells a security by means of ..."; §17(a), 15 U. S. C. §77q(a) "... in the [offer or] sale of any securities to obtain money or property by means of ..."; [language in brackets was added in 1954 amendments]), and with the 1936 antifraud amendment of Section 15 of the Securities Exchange Act of 1934 (§15(c)(1), 15 U. S. C. §78*o*(c)(1) "... effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security ...") demonstrate that when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear. See Bromberg, *op. cit. supra* Table 1 at 16-17.

Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with a purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives; indeed, the obvious purposes of the Act to protect the investing public and to secure fair dealing in the securities markets would be seriously undermined by applying such a gloss onto the legislative language. Absent a securities transaction by an insider it is almost impossible to prove that a wrongful purpose moti-

vated the issuance of the misleading statement. The mere fact that an insider did not engage in securities transactions does not negate the possibility of wrongful purpose; perhaps the market did not react to the misleading statement as much as was anticipated or perhaps the wrongful purpose was something other than the desire to buy at a low price or sell at a high price. Of even greater relevance to the Congressional purpose of investor protection is the fact that the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose. We do not believe that Congress intended that the proscriptions of the Act would not be violated unless the makers of a misleading statement also participated in pertinent securities transactions in connection therewith, or unless it could be shown that the issuance of the statement was motivated by a plan to benefit the corporation or themselves at the expense of a duped investing public.

Nor is there anything about Rule 10b-5 which demonstrates that the SEC sought by the Rule not fully to implement the Congressional purpose and objectives underlying Section 10(b). See Securities Exchange Act of 1934, Release No. 3230 (May 21, 1942); 10 SEC Ann. Rep. 56-7 (1944); 8 SEC Ann. Rep. 10 (1942). To be sure, SEC official publicity accompanying the promulgation of the Rule emphasized the insider trading aspects of the Rule, particularly the prohibition against purchases by insiders, but this was emphasized because "the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers," 8 SEC Ann. Rep. 10, and the Commission wished to make it emphatically clear that the Rule was expected, *inter alia,* to close this loophole.

The foregoing discussion demonstrates that Congress intended to protect the investing public in connection with their purchases or sales on Exchanges from being misled by misleading statements promulgated for or on behalf of corporations irrespective of whether the insiders contemporaneously trade in the securities of that corporation and irrespective of whether the corporation or its management have an ulterior purpose or purposes in making an official public release. Indeed, the Commission has been charged by Congress with the responsibility of policing all misleading corporate statements from those contained in an initial prospectus to those contained in a notice to stockholders relative to the need or desirability of terminating the existence of a corporation or of merging it with another. To render the Congressional purpose ineffective by inserting into the statutory words the need of proving, not only that the public may have been misled by the release, but also that those responsible were actuated by a wrongful purpose when they issued the release, is to handicap unreasonably the Commission in its work. We should have in mind the wise words of Judge Learned Hand in *Cawley* v. *United States,* 272 F. 2d 443, 445 (2 Cir. 1959), relative to an interpretation of the words contained within a congressional statute, that " . . . unless they explicitly forbid it, the purpose of a statutory provision is the best test of the meaning of the words chosen. We are to put ourselves so far as we can in the position of the legislature that uttered them, and decide whether or not it would declare that the situation that has arisen is within what it wishes to cover. Indeed, at times the purpose may be so manifest as to override even the explicit words used. *Markham* v. *Cabell,* 326 U. S. 404."

As was pointed out by the trial court, 258 F. Supp. at 293, the intent of the Securities Exchange Act of 1934 is

the protection of investors against fraud. Therefore, it would seem elementary that the Commission has a duty to police management so as to prevent corporate practices which are reasonably likely fraudulently to injure investors. And, of course, as we have already emphasized, a corporation's misleading material statement may injure an investor irrespective of whether the corporation itself, or those individuals managing it, are contemporaneously buying or selling the stock of the corporation. Therefore, when materially misleading corporate statements or deceptive insider activities have been uncovered, the courts, as they should, have broadly construed the statutory phrase "in connection with the purchase or sale of any security." *Freed* v. *Szabo Food Serv., Inc.*, CCH Fed. SEC L. Rep. ¶91,317 (N. D. Ill. 1964); *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (SDNY 1965); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (SDNY 1964); *Miller* v. *Bargain City, U. S. A., Inc.*, 229 F. Supp. 33, 37 (E. D. Pa. 1964); see Ruder, Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur, 61 Nw. U. L. Rev. 872, 895 (1967). The court below found: "There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage." 258 F. Supp. at 294. The requirement that a statement may not be found misleading unless its issuance is actuated by a "wrongful purpose" might well have the effect of permitting the issuers of misleading statements to seek an advantage but to escape liability if the advantage fails to materialize to the degree contemplated, or cannot be demonstrated.

More important, however, is the realization which we must again underscore at the risk of repetition, that the investing public is hurt by exposure to false or deceptive

statements irrespective of the purpose underlying their issuance.[27] It does not appear to be unfair to impose upon corporate management a duty to ascertain the truth of any statements the corporation releases to its shareholders or to the investing public at large. Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media, Fleischer, *supra,* 51 Va. L. Rev. at 1294-95, if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated.

C. *Did the Issuance of the April 12 Release Violate Rule 10b-5?*

Turning first to the question of whether the release was misleading, i.e., whether it conveyed to the public a false impression of the drilling situation at the time of its issuance, we note initially that the trial court did not actually decide this question. Its conclusion that "the Commission has failed to demonstrate that it was false, misleading or deceptive," 258 F. Supp. at 294, seems to have derived from its views that "The defendants are to be judged *on the facts known to them* when the April 12 release was issued," 258 F. Supp. at 295 (emphasis supplied), that the draftsmen "exercised reasonable business judgment under the

27 See the discussion in footnotes 20, 21, and 22, *supra,* and in the accompanying text, dispensing with a fraudulent intent requirement in actions based on clause (3) of Rule 10b-5.

circumstances," 258 F. Supp. at 296, and that the release was not "misleading or deceptive *on the basis of the facts then known,*" 258 F. Supp. at 296 (emphasis supplied) rather than from an appropriate primary inquiry into the meaning of the statement to the reasonable investor and its relationship to truth. While we certainly agree with the trial court that "in retrospect, the press release may appear gloomy or incomplete,"[28] 258 F. Supp. at 296, we

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28 Examined in retrospect, the situation in Timmins at the time the release was prepared seems to offer good reason for optimism. The draftsmen of the release had full knowledge of the discoveries up to 7:00 P.M. on Friday, April 10. At that time approximately 2/3 of the ore ultimately found to exist by the time of the preparation of the April 16 "major strike" release had been discovered by 5 holes placed so as to indicate continuity of mineralization within the large anomaly. As of that time SEC experts estimated ore reserves of over 8 million tons at a gross assay value (excluding costs) of over $26 a ton. Accepting the conservative view of TGS's expert Wiles that 95.2% would be absorbed by costs, the ultimate profit could then have been estimated at more than $14,000,000. TGS experts could name very few base metal mines with a greater assay value and the court observed that bodies of much lower assay value were commercially mined, 258 F. Supp. at 282 n. 10. Roche, a mining stock specialist, added that mines with significantly lower percentages of copper and with no zinc or silver, as here, were profitably operated. On the basis of approximately one-third more data, and, for all the record shows, without any additional figures as to estimated costs, TGS announced on April 16 a major strike with over 25 million tons of ore. The trial court found that as of 7:00 P.M. on Thursday, April 9, "There was real evidence that a body of commercially mineable ore might exist." 252 F. Supp. at 282. And, by 7:00 A.M. on Sunday, April 10, eight hours before the release was issued to the press, 77.9% of the drilling in mineralization had been completed, 84.4% by 7:00 P.M. on the 12th, and 90.2% by 7 A.M. on April 13. The release did not appear in most newspapers of general circulation until later in the morning of Monday, the 13th.

The release, see pp. 3600-3601 *supra,* began by referring to rumored reports that the company had made a substantial copper discovery and then continued: "These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS." It then stated, purporting to give the true facts in contradiction to the rumors: "The facts are as follows." However, the "facts" disclosed relative to the Kidd-55 segment were: "Recent drilling on one property near Timmins has led to preliminary

cannot, from the present record, by applying the standard Congress intended, definitively conclude that it was deceptive or misleading to the reasonable investor, or that he would have been misled by it. Certain newspaper accounts of the release viewed the release as confirming the existence of preliminary favorable developments, and this optimistic view was held by some brokers, so it could be that the reasonable investor would have read between the lines of what appears to us to be an inconclusive and negative statement and would have envisioned the actual situation at the Kidd segment on April 12. On the other hand, in view of the decline of the market price of TGS stock from a high of 32 on the morning of April 13 when the release was disseminated to 29⅜ by the close of trading on April 15, and the reaction to the release by other brokers, it is far from certain that the release was generally interpreted as a highly encouraging report or even encouraging at all. Accordingly, we remand this issue to the district court that took testimony and heard and saw the witnesses for a determination of the character of the release in the light of the facts existing at the time of the release, by applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it.

In the event that it is found that the statement was misleading to the reasonable investor it will then become necessary to determine whether its issuance resulted from a lack of due diligence. The only remedy the Commission seeks against the corporation is an injunction, see footnote 26,

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indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable." It was then said that, as of April 12, the release date, ". . . any statement as to size and grade of ore would be premature and possibly misleading." A definite statement "to clarify" was promised in the future.

supra, and therefore we do not find it necessary to decide whether just a lack of due diligence on the part of TGS, absent a showing of bad faith, would subject the corporation to any liability for damages. We have recently stated in a case involving a private suit under Rule 10b-5 in which damages and an injunction were sought, " 'It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.' " *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F. 2d 540, 547, quoting from *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 193 (1963).

We hold only that, in an action for injunctive relief, the district court has the discretionary power under Rule 10b-5 and Section 10(b) to issue an injunction, if the misleading statement resulted from a lack of due diligence on the part of TGS. The trial court did not find it necessary to decide whether TGS exercised such diligence and has not yet attempted to resolve this issue. While the trial court concluded that TGS had exercised "reasonable *business* judgment under the circumstances," 258 F. Supp. at 296 (emphasis supplied) it applied an incorrect *legal* standard in appraising whether TGS should have issued its April 12 release on the basis of the facts known to its draftsmen at the time of its preparation, 258 F. Supp. at 295, and in assuming that disclosure of the full underlying facts of the Timmins situation was not a viable alternative to the vague generalities which were asserted. 258 F. Supp. at 296.

It is not altogether certain from the present record that the draftsmen could, as the SEC suggests, have readily obtained current reports of the drilling progress over the weekend of April 10-12, but they certainly should have obtained them if at all possible for them to do so. However, even if it were not possible to evaluate and transmit

current data in time to prepare the release on April 12, it would seem that TGS could have delayed the preparation a bit until an accurate report of a rapidly changing situation was possible. See 258 F. Supp. at 296. At the very least, if TGS felt compelled to respond to the spreading rumors of a spectacular discovery, it would have been more accurate to have stated that the situation was in flux and that the release was prepared as of April 10 information rather than purporting to report the progress "to date." Moreover, it would have obviously been better to have specifically described the known drilling progress as of April 10 by stating the basic facts. Such an explicit disclosure would have permitted the investing public to evaluate the "prospect" of a mine at Timmins without having to read between the lines to understand that preliminary indications were favorable—in itself an understatement.

The choice of an ambiguous general statement rather than a summary of the specific facts cannot reasonably be justified by any claimed urgency. The avoidance of liability for misrepresentation in the event that the Timmins project failed, a highly unlikely event as of April 12 or April 13, did not forbid the accurate and truthful divulgence of detailed results which need not, of course, have been accompanied by conclusory assertions of success. Nor is it any justification that such an explicit disclosure of the truth might have "encouraged the rumor mill which they were seeking to allay." 258 F. Supp. at 296.

We conclude, then, that, having established that the release was issued in a manner reasonably calculated to affect the market price of TGS stock and to influence the investing public, we must remand to the district court to decide whether the release was misleading to the reasonable investor and if found to be misleading, whether the court in its discretion should issue the injunction the SEC seeks.

CONCLUSION

In summary, therefore, we affirm the finding of the court below that appellants Richard H. Clayton and David M. Crawford have violated 15 U. S. C. §78j(b) and Rule 10b-5; we reverse the judgment order entered below dismissing the complaint against appellees Charles F. Fogarty, Richard H. Clayton, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Earl L. Huntington, and Francis G. Coates, as we find that they have violated 15 U. S. C. §78j(b) and Rule 10b-5. As to these eight individuals we remand so that in accordance with the agreement between the parties the Commission may notice a hearing before the court below to determine the remedies to be applied against them. We reverse the judgment order dismissing the complaint against Claude O. Stephens, Charles F. Fogarty, and Harold B. Kline as recipients of stock options, direct the district court to consider in its discretion whether to issue injunction orders against Stephens and Fogarty, and direct that an order issue rescinding the option granted Kline and that such further remedy be applied against him as may be proper by way of an order of restitution; and we reverse the judgment dismissing the complaint against Texas Gulf Sulphur Company, remand the cause as to it for a further determination below, in the light of the approach explicated by us in the foregoing opinion, as to whether, in the exercise of its discretion, the injunction against it which the Commission seeks should be ordered.

FRIENDLY, *Circuit Judge* (concurring):

Agreeing with the result reached by the majority and with most of Judge Waterman's searching opinion, I take a rather different approach to two facets of the case.

I.

The first is a situation that will not often arise, involving as it does the acceptance of stock options during a period when inside information likely to produce a rapid and substantial increase in the price of the stock was known to some of the grantees but unknown to those in charge of the granting. I suppose it would be clear, under *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2 Cir. 1964),[1] that if a corporate officer having such knowledge persuaded an unknowing board of directors to grant him an option at a price approximating the current market, the option would be rescindable in an action under Rule 10b-5. It would seem, by the same token, that if, to make the pill easier to swallow, he urged the directors to include others lacking the knowledge he possessed, he would be liable for all the resulting damage. The novel problem in the instant case is to define the responsibility of officers when a directors' committee

1 Since none of the parties has raised the question, I assume the continuing vitality of *Ruckle*, despite what have been regarded as contrary intimations in *O'Neill* v. *Maytag*, 339 F. 2d 764 (2 Cir. 1964), a decision that has not found favor with other circuits. Cf. *Dasho* v. *The Susquehanna Corp.*, 380 F. 2d 262 (7 Cir.), cert. denied, 381 U. S. 977 (1967); *Pappas* v. *Moss*, 393 F. 2d 865 (3 Cir. 1968); see Jennings, Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations under Rule 10b-5, 62 Nw. U. L. Rev. 809, 830-33 (1968). If we were writing on a clean slate, I would have some doubt whether the framers of the Securities Exchange Act intended §10b to provide a remedy for an evil that had long been effectively handled by derivative actions for waste of corporate assets under state law simply because in a particular case the waste took the form of a sale of securities. We will shortly be exploring this issue in the *in banc* consideration of *Schoenbaum* v. *Firstbrook*, slip opinions 2459

administering a stock option plan proposes of its own initiative to make options available to them and others at a time when they know that the option price, geared to the market value of the stock, did not reflect a substantial increment likely to be realized in short order and was therefore unfair to the corporation.

A rule requiring a minor officer to reject an option so tendered would not comport with the realities either of human nature or of corporate life. If the SEC had appealed the ruling dismissing this portion of the complaint as to Holyk and Mollison, I would have upheld the dismissal quite apart from the special circumstance that a refusal on their part could well have broken the wall of secrecy it was important for TGS to preserve. Whatever they knew or didn't know about Timmins, they were entitled to believe their superiors had reported the facts to the Option Committee unless they had information to the contrary. Stephens, Fogarty and Kline stand on an altogether different basis; as senior officers they had an obligation to inform the Committee that this was not the right time to grant options at 95% of the current price. Silence, when there is a duty to speak, can itself be a fraud. I am unimpressed with the argument that Stephens, Fogarty and Kline could not perform this duty on the peculiar facts of this case, because of the corporate need for secrecy during the land acquisition program. Non-management directors would not normally challenge a recommendation for postponement of an option plan from the President, the Executive Vice President, and the Vice President and General Counsel. Moreover, it should be possible for officers to communicate with directors, of all people, without fearing a breach of confidence. Hence, as one of the foregoing hypotheticals suggests, I am not at all sure that a company in the position

of TGS might not have a claim against top officers who breached their duty of disclosure for the entire damage suffered as a result of the untimely issuance of options, rather than merely one for rescission of the options issued to them.[2] Since that issue is not before us, I merely make the reservation of my position clear.

II.

The second point, to me transcending in public importance all others in this important case, is the press release issued by TGS on April 12, 1964. This seems to me easier on the facts but harder on the law than it does to the majority.

No one has asserted, or reasonably could assert, that the purpose for issuing a release was anything but good. TGS felt it had a responsibility to protect would-be buyers of its shares from what it regarded as exaggerated rumors first in the Canadian and then in the New York City press, and none of the individual defendants sought to profit from the decline in the price of TGS stock caused by the release. I find it equally plain, as Judge Waterman's opinion convincingly demonstrates, that the release did not properly convey the information in the hands of the draftsmen on April 12, even granting, as I would, that in a case like this

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2 Though the Board of Directors of TGS ratified the issuance of the options after the Timmins discovery had been fully publicized, it obviously was of the belief that Kline had committed no serious wrong in remaining silent. Throughout this litigation TGS has supported the legality of the actions of all the defendants—the company's counsel having represented, among others, Stephens, Fogarty and Kline. Consequently, I agree with the majority in giving the Board's action no weight here. If a fraud of this kind may ever be cured by ratification, compare *Continental Securities* v. *Belmont*, 206 N. Y. 7 (1912), with *Claman* v. *Robertson*, 164 Ohio St. 61 (Sup. Ct. 1955); cf. *Wilko* v. *Swan*, 346 U. S. 427 (1953), that cannot be done without an appreciation of the illegality of the conduct proposed to be excused, cf. *United Hotels Co.* v. *Mealey*, 147 F. 2d 816, 819 (2 Cir. 1945).

a court should not set the standard of care too high. To say that the drilling at Timmins had afforded only "preliminary indications that more drilling would be required for proper evaluation of this prospect," was a wholly insufficient statement of what TGS knew. Cf. *Gediman* v. *Anheuser Busch, Inc.*, 299 F. 2d 537, 545 (2 Cir. 1962). Since the issue of negligence is open to full review, *Mamiye Bros.* v. *Barber SS. Lines*, 360 F. 2d 774 (2 Cir.), cert. denied, 385 U. S. 835 (1965); *Esso Standard Oil, S.A.* v. *S.S. Gasbras Sul*, 387 F. 2d 573 (2 Cir.), cert. denied, 36 L. W. 3443 (May 21, 1968), I see no need for a remand on that score. It is an equally needless exercise to require the district court to determine whether a reasonable investor would have been misled. The text of the release and the three point drop in the market price following its issuance in the face of press reports that would normally have led to a large and, as matters developed, justified increase, are sufficient proof of that.

The majority says that negligent misstatement by a corporation is enough for injunctive relief under Rule 10b-5 (2) in a proper case; it reserves the question, not here presented, whether the corporation is liable for damages. I think the remand should make crystal clear that the issue whether this is a proper case for an injunction remains open, and that with 49 private actions pending in the District Court for the Southern District of New York, see 258 F. Supp. 262, 267 n. 1 (1966), some of which may involve this issue, we should explicate more clearly why, despite the principle that a violation of the securities laws or regulations generally gives rise to a private claim for damages, see *J. I. Case Co.* v. *Borak*, 377 U. S. 426 (1964), violation of Rule 10b-5(2) may not do so under all circumstances, including those presented by the April 12 press release.

The attention this case has received from the profession and our *in banc* consideration make it incumbent on us to give the district courts in our circuit as much guidance as we can.

A.

The consequences of holding that negligence in the drafting of a press release such as that of April 12, 1964, may impose civil liability on the corporation are frightening. As has been well said, of a situation where time pressures and consequent risks were less, "One source of perplexity as to the appropriate bounds of the civil remedy for misleading filings is that any remedy imposed against the issuer itself is indirectly imposed on all holders of the common stock, usually the most important segment of the total category of investors intended to be protected." Milton Cohen, Truth in Securities Revisited, 79 Harv. L. Rev. 1340, 1370 (1967). Beyond this, a rule imposing civil liability in such cases would work directly counter to what the SEC has properly called "a commendable and growing recognition on the part of industry and the investment community of the importance of informing security holders and the public generally with respect to important business and financial developments." Securities Act Interpretation Release No. 3844 (Oct. 8, 1957). If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.

The derivation of Rule 10b-5 is peculiar. Although the authority for the Rule comes from §10b of the Securities

and Exchange Act of 1934, the draftsmen turned their backs on the language of that section and borrowed the words of §17 of the Securities Act of 1933, simply broadening these to include frauds on the seller as well as on the buyer. So far as concerns paragraphs (1) and (3), this is not very important since these are clearly within the ambit of §10b and relate to frauds that would give rise to civil liability in any event. But the case stands differently as to paragraph (2). The only provision in either the 1933 or the 1934 Act that can be read to impose liability for damages for negligent misrepresentation without restrictions as to the kinds of plaintiffs, due diligence defenses, a short statute of limitations, or an undertaking for costs that were insisted on by the investment community, is §17(a)(2) of the Act of 1933—the source of Rule 10b-5(2).[3] But there is unanimity among the commentators, including some who were in a peculiarly good position to know, that §17(a)(2) of the 1933 Act—indeed the whole of §17—was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§11 and 12. See Landis, Liability Sections of Securities Act, 18 Am. Acct. 330, 331 (1933); Douglas and Bates, Federal Securities Act of 1933, 43 Yale L. J. 171, 181-82 (1933); 3 Loss, Securities Regulation 1785-86 (1961). When the House Committee Report listed the sections that "define the civil liabilities imposed by the Act" it pointed only to §§11 and 12 and stated that "[t]o impose a greater responsibility [than that provided by §§11 and 12] . . . would unnecessarily restrain the conscientious administration of

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3 Of course, §12(1)'s imposition of a liability almost absolute upon the seller of a security that has not been registered in violation of §5 of the 1933 Act is grounded on distinctive concerns. See 3 Loss, Securities Regulation 1692-96 (1961).

honest business with no compensating advantage to the public." H. Rep. No. 85, 73d Cong., 1st Sess. 9-10 (1933). Once it had been established, however, that an aggrieved buyer has a private action under §10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under §17—with the important proviso that fraud, as distinct from mere negligence, must be alleged. See *Fischman* v. *Raytheon Mfg. Corp.*, 188 F. 2d 783, 787 n. 2 (2 Cir. 1951); *Weber* v. *C. M. P. Corp.*, 242 F. Supp. 321, 322-25 (S. D. N. Y. 1965) (Wyatt, *J.*); *Thiele* v. *Shields*, 131 F. Supp. 416, 419 (S. D. N. Y. 1955) (Kaufman, *J.*); but see *Dack* v. *Shanman*, 227 F. Supp. 26 (S. D. N. Y. 1964). To go further than this, as Professor Loss powerfully argues, Securities Regulation at 1785, would totally undermine the carefully framed limitations imposed on the buyer's right to recover granted by §12(2) of the 1933 Act.

Even if, however, we were to disregard the teaching of Judge Frank in *Fischman* v. *Raytheon Mfg. Corp.*, *supra*, 188 F. 2d at 786, and follow the lead of those Circuits that seem to have discarded the *scienter* requirement in actions for damages under Rule 10b-5,[4] *Ellis* v. *Carter*, 291 F. 2d 270, 274 (9 Cir. 1961); *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210, 212 (9 Cir. 1962); *Kohler* v. *Kohler Co.*, 208 F. Supp. 808, 823 (E. D. Wisc. 1962) (dictum), aff'd, 319 F. 2d 634 (7 Cir. 1962); *Stevens* v. *Vowell*, 343 F. 2d 374 (10 Cir. 1965); *Myzel* v. *Fields*, 386 F. 2d 718 (8 Cir. 1967);

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4 The imposition of liability on Clayton, Crawford and Coates for "beating the gun" does not require any such metamorphosis of Judge Frank's concept of fraud as the majority opinion seeks to perform. The only one of these defendants who came close to a showing of good faith was Coates. But even he did not act on the belief that the second press release had in fact reached the market, see 258 F. Supp. at 288; his defense was rather a belief that the law required him only to await its issuance. While such an erroneous view of the law is pardonable, it is not "good faith" in a legal sense.

we should not impose such expansive liability in a situation, markedly different from those considered in the cases just cited, where to do so would frustrate, not further, the larger goals of the securities laws. While I am not convinced that imposition of liability for damages under Rule 10b-5(2), absent a *scienter* requirement, even limited in the way just proposed, would not go beyond the authority vested in the Commission by §10b to act against "any manipulative or deceptive device or contrivance" and be so inconsistent with the general structure of the statutes as to be impermissible, it is at least clear that the April 12 press release would be the worst possible case for the award of damages for merely negligent misstatement, as distinguished from the kind of recklessness that is equivalent to wilful fraud, see *SEC* v. *Frank,* 388 F. 2d 486, 489 (2 Cir. 1968).

The issue here, however, is the different one of an injunction. Mr. Justice Goldberg noted in *SEC* v. *Capital Gains Research Bureau,* 375 U. S. 180, 193 (1963), that the elements of a cause of action for "fraud" vary "with the nature of the relief sought" and that "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for money damages." See also *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F. 2d 540, 547 (2 Cir. 1968). It can, indeed, be argued that, even on this basis, Rule 10b-5(2), absent the reading in of a *scienter* requirement, goes beyond the authority granted by §10b of the 1934 Act. However, it cannot be doubted that one of the most important purposes of the securities legislation was to prevent improper information being circulated by the issuer, and I therefore am not disposed to hold that Congress meant to deny a power whose use in appropriate cases can be of such great public benefit and do so little harm to legitimate activity.

B.

However, it does not necessarily follow that this is an appropriate case for granting an injunction as to future press releases. While we have often said that "a cessation of the alleged objectionable activities by the defendant in contemplation of an SEC suit will not defeat the district court's power to grant an injunction restraining continued activity," *SEC* v. *Boren*, 283 F. 2d 312 (2 Cir. 1960), and cases there cited, it is likewise true that an isolated violation, especially in the absence of bad faith, does not *require* such relief. *SEC* v. *Torr*, 87 F. 2d 446 (2 Cir. 1937). Absent much clearer language than is found in the 1934 Act, the entitlement of a plaintiff to an injunction thereunder remains subject to principles of equitable discretion. The Supreme Court made this clear beyond peradventure in the leading case of *Hecht Co.* v. *Bowles*, 321 U. S. 321 (1944). See 3 Loss, Securities Regulation 1975-83 (1961). Here there is no danger of repetition of an unduly gloomy press release like that of April 12. The essence of the SEC's case is that Timmins was a once-in-a-lifetime affair; the company's motive in issuing the release was laudable; and the defect was solely a pardonable one of execution. If Judge Bonsal had denied an injunction on these grounds, I see no basis on which we could properly have reversed him. Instead he acted on the view, erroneous in the court's belief, that no violation of the Rule had occurred and he was thus without power to enjoin, 259 F. Supp. 296. Although I see no reason why we could not affirm nevertheless, I am content to leave it for him to consider whether, although he has power to issue an injunction, there is equity in this portion of the bill. My concurrence in the disposition of the press release issue assumes that such consideration is permitted.

KAUFMAN, *Circuit Judge* (concurring):

I concur in Judge Waterman's reasoned and thorough opinion and in the court's disposition of the instant appeal. I agree with Judge Friendly, however, that we should provide guidance to the District Courts with respect to pending private claims for damages based upon Rule 10(b)(5) arising out of the transactions now before us. And, I concur in as much as Part II of Judge Friendly's opinion as discusses the origins of the rule and the relevance of today's decision —involving only an application by the S. E. C. for an injunction—to private damage actions.

ANDERSON, *Circuit Judge* (concurring):

I concur in Judge Waterman's majority opinion and I concur in the discussion of law set forth in Part II of Judge Friendly's concurring opinion.

HAYS, *Circuit Judge* (concurring in part and dissenting in part):

I concur generally with Judge Waterman in his views as to the proper interpretation of Section 10(b) and Rule 10b-5 and as to the standards which are to be employed in the application of the statute and the rule.

With the exception of Stephens and Fogarty as recipients of stock options, I agree with the majority on the disposition of the cases involving individuals.

I do not agree on the remand of the issue with respect to Stephens and Fogarty as recipients of stock options. It seems to me clear that the injunction sought by the Commission should be granted.

The majority remand the case against the corporate defendant to the district court for a determination as to

whether the April 12 press release was misleading and whether, if so, those responsible for the release used due diligence.

In my opinion the evidence establishes as a matter of law that the press release was misleading. Indeed, if the correct standard is applied, the finding of the trial court requires the conclusion that the press release was misleading:

> "At 7:00 p.m. on April 9, those with knowledge of the drilling results had material information which it was reasonably certain, if disclosed, would have had a substantial impact on the market price of TGS stock."

The evidence in the record in support of this finding is overwhelming.

Assuming arguendo that the corporation cannot be enjoined except on a showing of lack of due diligence, since Fogarty and those who assisted him in the preparation of the press release were aware of the drilling results to which the district court's finding refers, they obviously did not use due diligence in the preparation of the misleading press release.

I would grant the application for an injunction.

MOORE, *Circuit Judge* (dissenting) (with whom Chief Judge LUMBARD concurs):

In their opinion, the majority have become so involved in usurping the function of the trial court, in selecting the witnesses they (at variance with the trial court) choose to believe, in forming their own factual conclusions from the evidence (in disregard of Rule 52a), in deciding with, of course, the benefit of the wisdom of hindsight, how they, had they been executives of Texas Gulf Sulphur Company (TGS), would have handled the publicity attendant to the

exploration of the Timmins property, in determining (to their own satisfaction) the motives which prompted each of the individual defendants to buy TGS stock and in becoming mining engineering experts in their own right, that I find it desirable—in fact, essential—to state my opinion as to the fundamental jurisdiction of the Court of Appeals and the issues properly before us. Primarily, our task should be to review errors of law. Conversely, we are not a jury of nine with no requirement of a unanimous verdict.

If the facts are to be reappraised by an appellate court, they should be measured *mutatis mutandis* in accordance with the standard set for himself by an experienced and learned trial judge who stated his approach in a case charging directors with wrongdoing, as follows:

> "The Court has endeavored * * * to judge the transactions in issue in this case by the applicable legal standards but without the benefit of hindsight as to the facts." (Herlands, *D.J., in Marco, etc.* v. *The Bank of New York, etc.*, 272 F. Supp. 636, 639 (S. D. N. Y., 1967).)

More, specifically, the Court in *Marco* said:

> "The Court is asked by plaintiff, in effect, to substitute its judgment for that of the directors with respect to transactions affecting the internal affairs of the corporation in question. * * * As directors they were, of course, required to perform their duties in accordance with the high standards of fidelity, honesty and prudence applicable to fiduciaries." (p. 639)

The Securities and Exchange Commission (referred to as the "SEC" and "Commission"), as an agency of government, has the responsibility of prosecuting persons who,

and corporations which, in its judgment have violated laws which the Congress has enacted for the praiseworthy purpose of protecting the public from securities frauds. However, as such an enforcement agency, where it assumes a plaintiff's role it must bear the evidentiary fair preponderance burden of all litigants and be subject to the rule that the determination of what evidence is "credible" is for the trial judge.

The Issues

The case logically and chronologically can be divided into two parts: (1) the purchase of TGS stock by individual defendants and stock options issued to them between November 12, 1963 and April 9, 1964, and (2) the TGS press release of April 12, 1964. The stock purchases by Clayton, Crawford and Coates on April 16, 1964, are considered later.

(1) In resolving the stock purchase issue, the primary factual inquiry must be concentrated on (a) the nature and extent of the knowledge possessed by, or available to, the purchaser on the date of purchase, and (b) the position of the purchaser in relation to TGS. The primary legal issue in substance is what duty, if any, rested upon the purchasers to disclose the knowledge they possessed at the time of purchase. The Commission argues that there was a failure to disclose material information. The trial court based its opinion largely upon the lack of materiality of such exploration results as were known between November 12, 1963 and April 9, 1964.

(2) Was the TGS press release of April 12, 1964, false, misleading or deceptive within the meaning of Section 10(b) and Rule 10b-5 in the light of TGS' then knowledge and the then existing factual situation.

The Facts

By-passing momentarily the general knowledge possessed by the officers of TGS as to the far-flung nature of the company's operations, its heavy concentration in the sulphur field, its non-engagement in the field of copper mining, the adverse effect which low sulphur prices had had for many years on the company's earnings despite substantial sales and focusing attention solely upon the Timmins property, the participants in that exploration and the knowledge available to them, I find no factual disputes of importance.

On November 8, 1963, TGS, selecting the most promising area of the one-quarter section then controlled by it, referred to as Kidd 55, drilled an exploratory hole, 1⅛ inches in diameter. All the information that was available upon the completion of the drilling, November 12, 1963, was contained in a core (denominated K-55-1) which was visually examined by Dr. Walter Holyk, Chief Geologist for TGS, and by Kenneth H. Darke, a TGS geologist. This core was unusually good in mineral content. The President, Claude O. Stephens, the Executive Vice-President, Charles F. Fogarty, and the Exploration Vice-President, Richard D. Mollison, were notified, and Fogarty and Mollison flew to the drill site.

In order to acquire the other three-quarters of the K-55 segment, further drilling was discontinued except for one hole drilled to produce a barren core and the site was camouflaged. Thus, but for a chemical assay made in December 1963 of contents of this same core, no other knowledge of the nature and possible extent of the area was available during the acquisition program.

Rule 52(a) should be given particular weight where expert testimony must of necessity play an important role. Here the trial court had an opportunity not only to hear

the qualifications of the experts but also from their demeanor and responses to form its opinion as to their credibility. The importance of this opportunity to observe where technical or scientific problems are before the court, as here, has been succinctly stated by the Supreme Court in *Graver Tank & Mfg. Co.* v. *Linde Air Prods. Co.*, 339 U. S. 605 (1950):

> "Like any other issue of fact, final determination requires a balancing of credibility, persuasiveness and weight of evidence. It is to be decided by the trial court and that court's decision, under general principles of appellate review, should not be disturbed unless clearly erroneous. Particularly is this so in a field where so much depends upon familiarity with specific scientific problems and principles not usually contained in the general storehouse of knowledge and experience." (pp. 609-610)
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> "It is not for this Court [the Supreme Court] to even essay an independent evaluation of this evidence. This is the function of the trial court. And, as we have heretofore observed, 'To no type of case is this . . . more appropriately applicable than to the one before us, where the evidence is largely the testimony of experts as to which a trial court may be enlightened by scientific demonstrations. * * *' 336 U. S. 271, 274-5." (p. 611)

No more is it for this court to make an independent essay of the evidence or of the core. Wanting the knowledge requisite to making our own appraisal of the significance of the core, we must depend upon the experts. A correct decision in this case may well hang upon their testimony

and its credibility because what these observers knew or should have known between November 12, 1963 and April 9, 1964 is basic to a determination of what, if anything, should have been disclosed or whether it was "material."

For the defendants, Dean Forrester, Dean of the College of Mines of the University of Arizona and Director of the Arizona Bureau of Mines, said that "one hole is evidence of what you encounter only in that hole" and that even after K-55-3 was drilled in April 1964, it was "much more likely that the materials exposed in those two holes will extend for, let's say, two feet outside the limits of the hole than it is likely that it will extend 25 feet or that it will extend 50 feet."

Dr. Park, former Dean of the School of Earth Sciences at Stanford, admitted that K-55-1 was "an interesting one, a good one" but that there was not "any evidence at all for any discussion of extent, from one drill hole." Dr. Lacy, head of the mining department of the University of Arizona, was of the opinion that "There is no basis for making any sort of prediction out from the hole."

Wiles, a consulting mining engineer, conceded that K-55-1 was a remarkable drill hole but that he could not estimate therefrom the probabilities of finding a commercially mineable body of ore, adding that he had had "the misfortune of having found a very attractive first hole and after drilling 52 around it got no more ore." Walkey, the manager of the Kamkotia, a mine some 12 miles distant from the Timmins property, testified that the geological composition of the Kamkotia and TGS areas was similar but that he could neither estimate nor say the chances were good of proving a substantial body of ore as a result of K-55-1.

Even the Commission's experts, Adelstein and Pennebaker, would not estimate what ore, if any, might lie beyond the 1⅛ inch core.

Adelstein:

"I think assay value given for a drill hole, standing by itself without surrounding information, cannot be interpreted by itself as to what it really means."

Pennebaker:

Q. You certainly couldn't compute any tonnage from that single hole, could you? A. No, sir.

Q. Nor could you compute any grade of ore beyond what was in the core itself? A. You are confined to what is in the core, sir.

[This witness did say that it was "inconceivable to expect the ore would quit immediately outside the drill hole, but you have no way of measuring how far it is going to go except the favorable implication of the anomaly."]

From this testimony, the trial court found:

"However, all the experts agreed that one drill core does not establish an ore body, much less a mine. Defendants' experts unanimously concluded that there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body." 258 F. Supp. at 282.

Despite the experts' virtually uncontradicted testimony, despite Rule 52(a) and despite the Supreme Court's statement of the law, the majority choose to reject the trial court's findings as to the results of the first drill core, K-55-1, and to substitute their own expertise in the mining engineering field by holding that "knowledge of the possibility which surely was more than marginal of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface (sug-

gesting mineability by the less expensive open-pit method) within the confines of a large anomaly (suggesting an extensive region of mineralization) might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell or hold."

Indeed, any such conclusions from a first drill core, if so announced by TGS, would undoubtedly have had a substantial effect on the market price of TGS stock and would have immediately brought forth both the wrath of, and injunction papers from, the Commission charging TGS with issuing false, misleading and unsupported statements to boost the price of the stock.

Factually, the premise posed by the majority is "clearly erroneous." There was no knowledge of the existence of a "mine." Even to the majority in their self-assumed fact-finding role, the "mine" was only a more than marginal "possibility." The testimony was unanimous that no estimate of "magnitude" could be made. The "large anomaly" did not suggest "an extensive region of mineralization" and furthermore TGS did not own or control it in any event. Its area was then limited to its one-quarter segment.

The majority read the record as conclusively establishing "that knowledge of the results of the discovery hole, K-55-1, would have been important to a reasonable investor and might have affected the price of the stock." But disclosure of the "results", namely, preliminary visual inspection of the contents, would have violated the Commission's own rules and standards. The Commission has specifically declared (Sch. I, Form 1-A, Reg. A offerings under the 1933 Act):

> "No claim shall be made as to the existence of a body of ore unless it has been sufficiently tested to be prop-

erly classified as 'proven' or 'probable' ore, as defined below. If the work done has not established the existence of proven or probable ore, a statement shall be made that no body of commercial ore is known to exist on the property."

Item 8(A)(b), 1 CCH Fed. Sec. L. Rep. ¶7327.

The Commission has carefully defined the scope of sampling required to justify even estimates, as follows:

"The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore."

Id., Item 8A(c), 1 CCH Fed. Sec. L. Rep. ¶7327.

Thus under the Commission's own standards, TGS, if it revealed any information during the November 1963-April 1964 period, would have had to announce to the public in substance "TGS has drilled a 1⅛" core on a one-quarter section owned by it in Timmins, Canada. Although the core appears to have excellent mineral content 'no body of commercial ore is known to exist on the property.'" Contrast such a statement with the April 12, 1964 release so criticized by the Commission. Further contrast it with a hypothetical November 1963 press release implicitly suggested by the majority "TGS as a result of drilling on its property in Canada has knowledge of the more than marginal possibility of a mine of magnitude over an extensive region of remarkably rich mineralization."—a statement which under the circumstances and then known facts would have been the height of recklessness.

In fact, the Commission itself indulges in the very speculation it condemns for, after conceding that "the trial court correctly stated that one drill hole does not establish the existence of a commercially mineable mineral deposit," it straightway contends that the information which arose after the drilling of this first and only (for 4½ months) drill hole revealed such "chances of imminent success, viewed in the light of the magnitude of the potential economic benefit to Texas Gulf" as to require disclosure by insiders desiring to buy TGS securities.

The Commission's position, consistent with its rules and regulations to protect the public from premature announcements which might well arouse speculative fervor are well expressed in its argument before this Court in its brief on appeal in *Securities and Exchange Commission* v. *Great American Industries, Inc., et al.*, 259 F. Supp. 99, S. D. N. Y., 1966, where it said:

> "Neither the Commission, the sellers, nor anyone else knew or could establish the value of the [mining] properties since they had not been explored except in a very preliminary way. No one can prove the value of a largely unexplored mining prospect" (p. 19).

The conservative (and in my opinion proper) approach of the Commission in *Great American* is reflected in its statement that "The ore content of a property is never 'known' until the ore has been completely removed and the minerals separated." This is probably an overstatement because by the time of the TGS April 16, 1964 press release, exploration had advanced to a point where an estimate of the extent of the tonnage might have been rather accurately made. The Commission in that case also stated two truisms (1) that "it is extremely important that all facts relevant

to an estimate of the value of such property be disclosed," and (2) that "the judgment of the 'value' of this property is dependent upon the results of exploratory work • • •" (*Great American* brief, pp. 22, 23).

On November 12, 1963 drilling of K-55-1 was terminated at 655 feet. The core of the drill hole contained relatively high percentages of copper and zinc and some silver, although the percentages at any given point fluctuated widely. This result undoubtedly "excited the interest" of the TGS exploration team. TGS decided to acquire the surrounding plots in the Kidd 55 area to enable it fully to investigate the anomaly. The attempt to acquire the adjoining properties at reasonable prices (ultimately $52,500) and the strictures on secrecy are customary in the mining industry, especially when dealing with land of a highly uncertain value. After all, TGS had prior experience in exploration where initially promising situations turned out to be "duds." For example, the company had spent some $7,000,000 to purchase an underwater dome off the coast of Texas and an additional $1,000,000 to drill 21 holes before concluding that there was not enough sulphur in the dome to be of commercial interest.

However, until drilling was resumed, nothing further was learned about the ore content of the property other than as revealed in November and December 1963 from the analysis of K-55-1. The trial court's finding as to this fact is unassailable:

> "The most that can be said of the individual defendants' knowledge after the drilling of K-55-1 is that they had 'hopes, perhaps with some reason,' that it would lead to a mine. *James Blackstone Mem. Lib. Ass'n* v. *Gulf, M. & O. R. Co.*, 264 F. 2d 445, 450 (7th Cir. 1959). The results of K-55-1 were too 'remote'

> when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, i.e., to be deemed material." 258 F. Supp. at 283.

This conclusion is amply supported by the record. Kidd 55 was only one of several thousand anomalies (areas where there is unusual variation in the electrical conductivity of rocks) that TGS detected in its aerial exploration of the Canadian shield. Several hundred of these were considered worthy of further study and options on the land around them were acquired. The District Court found that "TGS had previously drilled 65 equally promising anomalies, but most of them had revealed either barren pyrite or graphite, while a few had shown marginal mineral deposits in insufficient quantities to be commercially mined" (258 F. Supp. at 271).

Against this factual background, what position should have been taken by those few officers and employees of TGS after they knew of the core, K-55-1, and the reports thereon made after visual inspection and analysis? There were several choices. Knowing that the nature and extent of this prospect could not be measured until further exploration was conducted and that further exploration had to await additional land acquisition they could have made no announcement as was the case here.

Turning now to the hypothesis of disclosure: As previously stated, any announcement of the discovery of a remarkable mine would have been both false and misleading. The Commission, however, impliedly suggests for affirmative answer the question: "Whether the chances of imminent success, viewed in the light of the magnitude of the potential economic benefit to Texas Gulf" did not require disclosure by insiders of the status of the drilling [then

only the first hole, K-55-1]? In the field of speculation, it would be interesting to know the position the Commission would have taken if TGS had announced that K-55-1 was "one of the most impressive drill holes completed in modern times" and that it "is just beyond your wildest imagination" (SEC Brief, p. 25). It requires no imagination to venture that such announcements might well have had the "wildest" impact on the market price of TGS stock.

Assuming the majority's and the Commission's full disclosure theory, would the facts as then developed have given the buying or selling public the so-called advantages possessed by the insiders? TGS could have announced by November 15, 1963 that it had completed a first exploratory hole, the core of which by visual examination revealed over a length of 599 of 655 feet drilled, an average copper content of 1.15%, zinc 8.64% or, had TGS waited until mid-December, by chemical analysis 1.18% copper, 8.26% zinc and 2.94% ounces of silver per ton; that TGS would try to acquire the other three-quarters of the segment unless the announcement boosted prices to unwarranted heights; that if the property could be acquired further exploratory holes would be drilled to ascertain the nature and extent, if any, of the ore body; that reports of developments would be made from time to time but that the SEC had indicated that TGS should advise its stockholders and the public that there was no proof as yet that a body of commercial ore exists on the property. Such an announcement would, of course, have been of no value to anyone except possibly a few graduates of Institutes of Technology and they, as the expert witnesses here, would have recognized that one drill hole does not reveal a commercially profitable mine.

The final question to be answered is: were these officers and employees disqualified as the result of possessing information gleaned by the first drill core from purchasing

TGS stock? The number of possibilities for Congressional legislation and Commission rulings are legion. They extend over a gamut between definite extremes. At one extreme is a rule that no officer or employee or any member of their families shall own stock of the company for which they work or purchase stock if he possesses "material" inside information. This assumption raises the question of what is material and who is to make such a determination. Materiality must depend upon the facts and their resolution is for the fact-finder, court or jury. The majority state that the K-55-1 drilling results were material because they "might well have affected the price of TGS stock." But such a statement could be made of almost any fact related to TGS. If a labor strike had kept its plants idle for months, encouraging news of a possible settlement hoped for by the TGS labor negotiators might cause the negotiators to buy. Their belief that the strike would be protracted might cause them to sell. Either announcement might well have affected the market and would to those who bought or sold have seemed misleading and deceptive if the anticipated event did not come to pass. Yet the requirement of hourly bulletins to the press from the conference room would not be compatible with common sense. Scores of day by day intra-company situations come to mind which in the individual opinions of company officers or employees might well affect the price of TGS stock, each individual reacting according to his own judgment. However, companies listed on a national exchange can scarcely broadcast to the nation on a daily basis their hopes and/or expectations from the developments in, for example, their research departments. An even more striking illustration would be found within the structure of a large pharmaceutical company where discoveries of panaceas to cure human disease occupies the workdays of thousands of scien-

tists. Premature announcements of important discoveries would be branded as false and misleading if unfulfilled and all stock purchases made during the course of the research, if ultimately successful would be said to have been made with the advantage of inside information. At the other extreme is an equally easy-to-resolve *Cady, Roberts*[1] situation where a definite fact (the reduction of the dividend) was known by an insider, who participated in the meeting where the decision had already been made, whose knowledge of the probable reaction of the market to such an announcement, namely, a substantial sell-off, caused him to leave the meeting ahead of everyone else and before the potential buyers learned of the bad news to foist his selling orders on the market and his stock on uninformed purchasers. Between these extremes there should be a rule of reason.

Faced with this problem, the trial court selected a period from November 12, 1963 (the first information) to some date after drilling was resumed when it might reasonably be said that a body of commercially mineable ore *might* exist. The trial court, accepting the Commission's experts' version, fixed 7:00 p.m. on April 9, 1964 as the time when TGS had material information which "if disclosed, would have had a substantial impact on the market price of TGS stock" but also found that "the drilling results up to 7:00 p.m. on April 9th did not provide such material information." These findings are clearly supported by the proof upon which the court relied.

Practically all TGS stock in question here was purchased between November 12, 1963 and April 8, 1964. What were the motives behind each of the purchases? Obviously, a subjective approach presents difficulties. A myriad of reasons would be given—hope that a commercially profitable

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1 *In re Cady, Roberts & Co.*, 40 SEC 907 (1961).

mine would be found if further exploration proved the ore to be as promising as the core of K-55-1 (November 12, 1963); the development of a phosphate project and potash mine (November 15, 1963); the prediction of security analysts that there would be a turnabout in the price of sulphur stocks; the acquisition of Canadian oil properties (December 16, 1963); the new high level of free world sulphur use and output (December 30, 1963); the launching of the world's largest liquid sulphur tanker (December 30, 1963); the entry into service of a large liquid sulphur tanker for domestic shipments (January 18, 1964); the sulphur expansion program in Canada (February 8, 1964); the new four-year high in sales reached in 1963 (February 20, 1964); and the $2 per ton price increase for sulphur (April 1, 1964).

There can be little doubt but that those familiar with the results of K-55-1 were influenced thereby in making their purchases. The conclusion of the majority is based primarily on this assumption. They call it "a major factor in determining whether the K-55-1 discovery was a material fact" and say that this "virtually compels the inference that the insiders were influenced by the drilling results." To them, completely disregarding the trial court's findings and substituting themselves as a jury, these purchases are "the only truly objective evidence of the materiality of the K-55-1 discovery." In so holding, they confuse the inducing motive of the individual purchaser with knowledge of material facts which ought to be revealed to the public at large. The inconsistency of the majority's position is immediately apparent. Those who purchased were apparently willing on the basis of the inconclusive first hole and other information to risk a certain amount of their funds in TGS stock, hopeful that

future developments would be favorable. Their motive for purchase does not establish the materiality of the facts which influenced them. However, the importance of this case to the corporate and financial community centers around the news release, its timing and its content. It is unfortunate that the atmosphere surrounding this important issue has been so colored and in the collective mind of the majority so contaminated by the comparatively insignificant stock purchase issue.

The resolution, if such be possible, of the many problems presented in this field should be by rule, as definite as possible, formulated in the light of reality and not retroactive in effect as here. I understand that the Commission has conducted, or is conducting, hearings to enable it to learn the views of the many persons and corporations affected. Presumably the Commission will make recommendations to the Congress to give that body an opportunity to accept or reject after thoughtful debate such proposals as may be made. The companies, the securities of which are listed on exchanges, their employees and investing public alike should have some knowledge of the rules which will govern their actions. They should not be forced, despite an exercise of the best judgment, to act at their peril or refrain *in terrorem* from acting. As to a waiting period after the information regarded as "material" has been disclosed, any such time period should be specifically fixed by Congressional or Commission rule not retroactive in application. There is no proof here that the purchases of the defendants, even if motivated by hopes not then solidly grounded, raised or lowered the market or were manipulative, misleading, deceptive or were accomplished by false or fraudulent devices. The trial court after hearing and seeing the witnesses has resolved these factual issues and in my opinion its decision should be sustained.

Stock Options

On February 20, 1964 the stock option committee, which was not informed of the developments at Kidd 55, granted options to Stephens, Fogarty, Mollison, Holyk, Kline and a number of other top officers of TGS. Since only K-55-1 had been drilled at that point, the District Court correctly held that there was no duty of disclosure on the part of those receiving the options. Assuming *arguendo* that the information was material, those not in top management have no duty to disclose to the directors information already reported to their own superiors since they may reasonably assume that the information has been conveyed to the directors on the stock option committee. The District Court held that Holyk, Mollison and Kline were not in top management and that Kline was ignorant of the details of the drilling results, so as to them no violation of 10b-5 had been made out. The majority disagree as to Kline, placing him in top management along with Stephens and Fogarty, and holding that he had sufficient knowledge that his nondisclosure violated Rule 10b-5. Since the majority admit that Kline "knew only that a hole containing favorable bodies of copper and zinc ore had been drilled in Timmins," it seems clear that he did not possess material information that had to be disclosed. That being the case, I find it unnecessary to decide whether or not Kline was in "top management."

As to Stephens and Fogarty, the majority decision places insider recipients of stock options in a difficult dilemma. Under the majority's decision, an insider must perform the uncommon act of refusing such an option, promoting speculation as to the reasons therefor, or accept the option and face possible 10b-5 liability. The objective of protecting a corporation from selling securities to insiders at a

price below their true worth is fully served by requiring nondisclosing insiders to abstain, not from accepting the stock options, but merely from exercising them—an event likely to occur after the inside information has become public. In any case, the failure to exercise an option is less likely to suggest that the insider possessed material information than the failure to accept such an option. Since the option granted to Kline had not been exercised prior to its ratification by the Texas Gulf directors on July 15, 1965, after full disclosure, there can be no 10b-5 violation as to him, and rescission of the option he received should not be ordered. As Stephens and Fogarty have surrendered the options and the corporation has canceled them, there has certainly been no violation of 10b-5 by them with respect to those options.

The April 12, 1964 Press Release

The majority suggest with, in my opinion, most remarkable business naivete that, instead of the April 12, 1964 press release which the trial court had found as a matter of fact had been issued in the exercise of "reasonable business judgment under the circumstances," in their 1968 judgment "it would have obviously been better to have specifically described the known drilling progress as of April 10th by stating the basic facts." They also suggest that "[s]uch an explicit disclosure would have permitted the investing public to evaluate the 'prospect' of a mine at Timmins without having to read between the lines to understand that preliminary indications were favorable—in itself an understatement." Had TGS followed this *ex post facto* directive, it first would have had to find some news medium capable of reaching the nation's potential investing public and willing to publish a mass of metallurgical reports disclosing

the "basic facts." Any such procedure would have invited the initial question on cross-examination of TGS officials: How could any such "explicit disclosure" have permitted the investing public to evaluate the prospect of a mine, without the necessity of transmitting it for expert opinion to some School of Mines? Of course there would be but one answer: It could not.

The facts as established between the date of the resumption of drilling and the drafting of the release are as follows:

On March 31, 1964 TGS moved four drill rigs onto the property, and by April 10th all were in operation. On Friday morning, April 10th, Mollison and Holyk visited the property and learned the results of the drilling up to that time. Mollison left for New York that evening, arriving on Saturday morning. Holyk left for New York Saturday morning and arrived that same day. Until Saturday morning TGS did not intend to issue a press release on the progress of the exploration.

Despite rumors in the Canadian press that TGS had made a major discovery, Lamont had advised Stephens "that TGS should take no action unless the rumors reached the New York press or until TGS had sufficient information available to issue an appropriate press release." 258 F. Supp. at 293. On Saturday morning, April 11th, both the New York Herald Tribune and the New York Times prominently reported a major ore discovery. In a front page article carrying the title "Canada's Copper Rush" the Herald Tribune stated "The biggest ore strike since gold was discovered more than 60 years ago in Canada has stampeded speculators to the snowbound old mining city of Timmins . . . ." The article also stated that the richness of the copper was so great that the core was flown out of the

country to be assayed and that four more drill rigs were scheduled to start working the following week. All of these statements were inaccurate and a matter of concern to Fogarty and Stephens.[2] Stephens advised Fogarty that TGS should issue a press release to clarify the rumors that Fogarty therefore contacted Mollison who had just returned from Timmins.

Mollison had been advised by Holyk as to the drilling results up to 7:00 p.m. on April 10th. On the basis of this information he, as an experienced mining engineer, did not feel that there was sufficient information to draw conclusions as to size and grade of ore, and he advised Fogarty accordingly.

The District Court held:

> "In seeking the advice of Mollison, the head of TGS's exploration group, in consulting with TGS's public relations firm, and in clearing the release with one of TGS's lawyers, Stephens and Fogarty exercised reasonable business judgment under the circumstances." 258 F. Supp. at 296.

The press release was drawn up with the aid of the above-mentioned persons on Saturday and Sunday morning, and was delivered to the press on Sunday for publication in the Monday papers. It stated in part:

> "Recent drilling on one ore property near Timmins has led to preliminary indications that more drilling

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2 The New York Stock Exchange Company Manual provides:

> "Dealing with Rumors Affecting the Market: Occasions may also arise when rumors have been circulated which have no basis in fact or which require clarification or interpretation and which also result in unusual activity or price changes in a particular security. Under such circumstances, the most effective procedure is the quick and speedy denial of such rumors through a release to the public Press . . ."

would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

"The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

The majority offer suggestions for improving the press release, but, as their editorial skills and present appraisal of the then mining situation were not available when it was drafted, the relevant issue is whether the District Court was in error in determining that the release was accurate and not misleading.

By 7:00 p.m., April 10, the following data was available:

1. geologists' logs of visual estimate and chemical assay of the results of K-55-1,
2. preliminary estimates of 757 feet of K-55-3 and unrecorded visual estimates of 569 feet of K-55-6, both drilled on the same line as K-55-1 (2400 S),
3. unrecorded visual appraisals of 476 feet of K-55-4, drilled 200 feet to the south of K-55-1, and
4. unrecorded visual appraisals of only 97 feet of K-55-5, drilled 200 feet to the north of K-55-1.

The Commission's experts testified that because copper and zinc had been found in these five holes (although in vary-

ing percentages) it could reasonably be concluded that the mineralization was continuous between holes 400 feet apart and also 100 feet beyond in each direction and to a depth of 600 feet, one hundred feet below the deepest hole. However, the District Court found that:

> "TGS's experts were unanimously of the opinion that at 7:00 p.m. on April 10 the Kidd 55 segment was still a prospect and that no estimates as to proven or probable ore could be made. They all agreed that the April 12 press release accurately set forth the situation as it was known at the time. None thought that TGS could have estimated proven ore, and the Commission's expert, Pennebaker, agreed that this was a matter on which there could be differences of opinion. Defendants' experts testified that on the basis of the drilling to that time there was no assurance of continuity in the mineralized zone and that, without further drilling, the results of one hole could not be correlated with the results of others." 258 F. Supp. at 295.

The April 12 release therefore correctly described Kidd 55 as a "prospect." While that term is a word of art in the mining trade used to describe "a property where there is no assurance, from the information known, that a commercially mineable ore body exists" [Pennebaker], its technical definition is no different from the definition in common use. See Webster's New International Dictionary (2d ed. unabridged 1960). Nor is there any inconsistency between the release and the District Court finding that as of April 9, 1964 "there was real evidence that a body of commercially mineable ore *might* exist." 258 F. Supp. at 282 (emphasis added). The District Court characterized the press release as an accurate portrayal of the situation as it was known

at that time. The inference is therefore inescapable that the Court felt that a reasonable investor would not be misled by it. The Commission's whole argument appears to be that the release should have been more optimistic (if conclusions were to be used at all), and that it should have referred to Kidd 55 as having "proven" or "probable" ore. But such a press release would have been highly misleading since the information necessary to draw such conclusions was not available on April 10—according to the TGS witnesses whom the District Court chose to believe.

As evidence that the April 12 release was probably inaccurate, the majority point to the fact that only three days later TGS prepared the April 16 release which announced a major mineral discovery. However, this release was based on more information of significance than was available on April 10 at 7:00 p.m. Between April 12 and April 15 five additional holes had been drilled, K-55-5, 6, 7, 8 and 10 and by April 15 at 7:00 p.m. 5198 feet of core had been drilled compared with 2776 feet on April 10. Furthermore, the location of drilling holes is critical in determining continuity. Most of the footage drilled by April 10 had been in a single plane (2400 S), but by April 15 drilling had established mineralization in a number of additional planes. There is therefore no inconsistency in the statements made and the conclusions reached in the two releases.

The majority remand for a determination of the effect of the April 12 release on a reasonable investor because in its opinion "the effect of this release on the investing public was equivocal and less than abundant." The evidence of the actual effect of the release on investors was at best inconclusive. The Commission offered no proof that anyone was misled by the release—e.g. testimony tending to show that most investors thought the release meant that TGS had no hopes of making an ore discovery. Those

that had been advised by the broker Roche to purchase stock did not sell upon reading the April 12 release. Several brokers testified that they interpreted the release as affirmative and encouraging. The market opened at 30⅛ on the 13th (when the release became public) and closed at 30⅞—scarcely a sign of public pessimism. The next day the market closed at 30¼. The District Court correctly found that "the issuance of the release produced no unusual market action." 258 F. Supp. at 294. Nor did he find the release to be "gloomy." His statement was that: "While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known." 258 F. Supp. at 296. With the aid of hindsight the release may indeed seem gloomy, but that is because it is now known that a very substantial tonnage of ore exists. Hindsight, however, is not the test. Furthermore, even if some investors considered the release to be discouraging compared to the rumors afloat, if the facts and conclusions presented were accurate (as they were) and if they were not presented in a manner that would mislead a reasonable investor (which they were not) then there can be no violation of 10b-5.

The District Court aptly pointed out that in quelling the rumors TGS had to proceed with caution:

> "If they said too much, they would have been open to criticism and possible liability if it turned out that TGS had not discovered a commercial mine. If they said too little and later announced a mine, they subjected themselves to the charge that their press release was misleading or deceptive—and, indeed, this is what has happened." 258 F. Supp. at 296.

While it thus might have been "safer" for TGS to have issued a sheaf of drilling results and mineral analyses

(which the press would probably have declined to print), "they would have [thereby] encouraged the rumor mill which they were seeking to allay." *(Ibid.)* Stephens and Fogarty decided that the best course was to give their evaluation of the situation—a reasonable business judgment that should not incur 10b-5 liability unless their evaluation was either false or misleading. The experts which the trial court credited were of the opinion that Kidd 55 was accurately portrayed as a prospect which required further exploration. The trial court found that the release was not "misleading or deceptive on the basis of the facts then known," and the majority state that from the record they cannot "definitively conclude that it was deceptive or misleading to the reasonable investor." It would therefore appear that the Commission has failed in its burden of proof, unless it can be said that TGS was negligent in not obtaining later data from Timmins before issuing the release.[3]

Of necessity the April 12 press release had to be issued on the basis of the drilling results through 7:00 p.m., April 10, and it seems clear that the trial court determined that it would not be reasonable to charge TGS with knowledge of later information. While additional drilling was done on Saturday and Sunday, April 11 and 12, the cores had not been seen by the geologists advising management, and there was no way of communicating with the drill site even if someone had been available there to give a reliable appraisal. Mollison and Holyk were in New York for the weekend, and there was no telephone at the site—the only way to communicate with the site was to go there. The decision to issue a press release was not made until Satur-

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3 Of course, even if TGS were negligent in not obtaining later data, a determination must still be made that the press release was misleading in light of this later information.

day, at which point Fogarty testified it "would just be very difficult for us to try to find anyone in Timmins." The statement was released Sunday afternoon and Mollison and Holyk were asked "to return to Timmins as promptly as possible and to move things along." It therefore cannot be said that TGS was negligent in not obtaining more current data, and it is certainly not negligent simply because it decided to issue the statement when it did. A remand on this point is therefore not justified.

The "in connection with" Clause Precludes the Imposition of §10(b) Liability on TGS.

In any event, the Commission still has the problem of showing that the other requirement of the statute and rule is met, namely that the release was issued "in connection with" a securities transaction on the part of TGS. This requirement is explicit in §10(b) of the Act (15 U. S. C. §78j) which provides:

> It shall be unlawful for any person . . .
>
> (b) To use, or employ, *in connection with the purchase or sale of any security* registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to this authority the Commission in 1942 promulgated Rule 10b-5 (17 C. F. R. §240.10b-5) which states:

> Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person . . .
>
> (a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security.*

In determining whether the requisite "connection" to a securities transaction was present in this case, the District Court found:

"From the foregoing, it is apparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment. There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage. The issuance of the release produced no unusual market action. In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or Rule 10b-5 since it was not issued 'in connection with the purchase or sale of any security.' " 258 F. Supp. at 294.

The District Court held that if TGS or its insiders had purchased TGS stock after issuing the allegedly misleading press release, the inference could be drawn that it was issued to reduce the price of the stock to facilitate purchases at bargain prices. Such a deceptive or manipulative

practice would be prohibited by 10(b) and Rule 10b-5. See *Gann* v. *BernzOmatic,* 262 F. Supp. 301 (SDNY 1966); *Cochran* v. *Channing Corp.,* 211 F. Supp. 239 (SDNY 1962). Moreover, noting that the "in connection" clause has been broadly construed, the District Court did not require that stock purchases by TGS or insiders be shown. Instead, the court held that "the issuance of a false and misleading press release may constitute a violation of Section 10(b) and Rule 10b-5 if its purpose is to affect the market price of the company's stock to the advantage of the company or its insiders. *Freed* v. *Szabo Food Serv., Inc.,* CCH Fed. Sec. L. Rep. ¶91,317 (N. D. Ill. 1964)." 258 F. Supp. at 293. Thus, even if TGS or its insiders had not engaged in securities transactions, if there were evidence from which it could be inferred that the press release was intentionally issued to depress the price of the stock as part of some fraudulent scheme, a 10b-5 violation would have been stated.[4] But in this case the only purpose of the press release was to quell the extravagant rumors circulating about the Canadian exploration project. No facts whatsoever were adduced which would have justified a finding that the release was issued for a fraudulent or manipulative purpose. To hold that such a statement incurs 10b-5 liability is contrary to the intent of Congress in passing §10(b) and settled judicial construction. Furthermore, such a holding might well have the unfortunate result of deterring the dissemination of corporate news despite the strong policy underlying all securities legislation of encouraging disclosure of information useful to present and potential investors. If press releases have to read like prospectuses to guard against possible 10b-5 liability, it is safe to predict that they will quickly fall out of favor with corporate management.

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4 Whether the release had any such effect would, of course, be irrelevant.

The Commission advances the argument (successful with the majority) that the "in connection" requirement is satisfied by the mere fact that the public is purchasing and selling securities on the open market. Thus any statement issued by a publicly listed company is made "in connection" with the purchase or sale of securities. The majority approve of this interpretation because "the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose." However, the fact remains that §10(b) of the Securities Exchange Act was not passed to protect investors from the former type of injury, but leaves liability for such misrepresentation up to state law, which is well equipped to handle any such situation. See, e.g., Note, Accountant's Liabilities for False and Misleading Statements, 67 Colum. L. Rev. 1437 (1967). Section 10(b) was certainly not intended to be a mandate to the Commission to erect a comprehensive regulatory system policing all corporate publicity, as the majority now contend. The legislative history clearly reveals that the statute was passed to prohibit deceptive and manipulative devices used in connection with securities transactions, and that the "connection" between the complained of conduct and the securities transactions must be a closer one than the majority now sanctions. See S. Rep. No. 792, 73rd Cong., 2d Sess. (1934); H. R. Rep. No. 1383, 73rd Cong., 2d Sess. (1934); S. Rep. No. 1455, 73rd Cong., 2d Sess. (1934); Comment, 74 Yale L. J. 658, 681-82 (1965).

The broad congressional purpose in passing the Securities Exchange Act of 1934 is set forth by Thomas G. Corcoran, one of the draftsmen of the bill that became the 1934 Act. He stated at a 1934 House hearing that "this bill has

at bottom five ideas in it, and all 36 pages tie in around the five ideas." According to Corcoran these five ideas were (1) control on the amount of credit, (2) control of manipulations, (3) control of insider trading [§16(b)], (4) elimination of abuses in the market machinery, and (5) the establishment of the Securities Exchange Commission to administer the Act. As to manipulation, he testified that:

> "As I will point out later, there are only a very few real battlegrounds in this act. Manipulation is not one of them. The provisions of this bill, as to manipulations upon stock exchanges, are agreed to practically everywhere, . . . Matched orders, washed sales, pools, options —all of the rest of them are out. So, control of manipulative practices is really not something your committee has to thrash out around this table."[5]

It is therefore not surprising that there is little discussion in the legislative history as to the meaning of the language in the anti-manipulation provisions. It was obviously thought that sections outlawing devices that had been shown at great length to be deleterious did not require any lengthy explication. This is unfortunate because it has resulted in §10(b) being given a construction and significance which, in my opinion, Congress did not foresee and did not intend.

Th. ; conclusion is fortified by the provisions of the Act dealing with manipulation since the more specific prohibitions make it clear what evils Congress intended to eradicate by §10(b). Section 9, 15 U. S. C. §78i provides that it shall be unlawful for any broker, dealer or other person to create a false or misleading appearance of activity in the

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5 Hearings before the House Committee on Interstate and Foreign Commerce on H. R. 7852 and H. R. 8720, 73rd Cong., 2d Sess. (1934).

market for a stock or to attempt to affect the price of a stock by certain specific manipulative devices.

Section 10(a), 15 U. S. C. §78j provides:

> Manipulative and Deceptive Devices
>
> It shall be unlawful for any person . . .
>
> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Read in context it seems clear that §10(b) was only meant to be a supplement to the specific prohibitions contained in §9 and §10(a). Commenting on the section that became §10(b), Corcoran stated:

> "Subsection [b] says, 'Thou shalt not devise any other cunning devices.' . . . Of course subsection [b] is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices."

Since the manipulative devices outlawed by §9 all involve fraudulent activities integrally related to securities transactions, the conclusion necessarily follows that the "other cunning devices" sought to be prohibited by §10(b) and Rule 10b-5 are those which also involve securities transactions as an integral part of the fraud. The statute as enacted requires that the fraudulent scheme be "in connection with the purchase or sale of any security." The

expression "in connection" is used elsewhere in the Act, including §9(b), as a shorthand method of indicating that the activity sought to be made illegal is that having a direct relation to securities transactions. The majority read the phrase as merely requiring that the allegedly misleading statement be issued by a publicly traded corporation. They argue that the "connection" that has to exist between a corporate statement and a security transaction is supplied by the theoretical argument that every "material" corporate statement presumably affects the market price of the issuer's securities. In my opinion such a broad interpretation of the statute is unwarranted as a matter of statutory construction and unwise as a matter of policy.

Congress has made it clear in the other antifraud provisions of general application that its concern was not with allegedly misleading corporate publicity but rather with purposeful schemes to deceive and defraud the public by means of manipulative and deceptive devices which directly involve purchases or sales of securities. Thus §12(a), 15 U. S. C. §77*l* of the 1933 Act provides that any person who "offers or sells a security" by means of a prospectus or oral communication which includes a misstatement or omission of a material fact shall be civilly liable. Similarly §17(a) of the 1933 Act, 15 U. S. C. §77q(a), provides that it "shall be unlawful for any person in the offer or sale of any securities" to engage in fraudulent activity.

A further insight into the proper scope of 10b-5 can be gained by examining §17(a), 15 U. S. C. §77g(a) which is almost word for word the same except for the explicit requirement that any alleged fraud be associated with "the offer or sale of . . . securities." The only difference of substance between §17(a) and Rule 10b-5 is that the latter applies to purchasers as well as sellers. *Ellis* v. *Carter*,

291 F. 2d 270, 272-274 (9th Cir. 1961); SEC Sec. Exch. Act Rel. No. 3230 (May 21, 1942) ("The new rule closes a loophole in the protection against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."); Milton Cohen, "Truth in Securities Revisited," 79 Harv. L. Rev. 1340, 1364 (1966).

Finally, §15(c)(1), (2), 15 U. S. C. §78o(c)(1), (2) provides that no broker or dealer shall (1) induce the purchase or sale of any security by means of any manipulative, deceptive or other fraudulent contrivance or (2) attempt to induce the purchase or sale of any security "in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice . . . ."

The majority argue that when compared with the above provisions the slight change of wording in §10(b)—the insertion of the phrase "in connection with . . . "—indicates that Congress intended a revolutionary change in the whole thrust of the securities laws. That is too slim a basis to support a judicial excursion over such uncharted seas. It is most doubtful that Congress intended such a result, and the merits of such a change are so unexplored that Congress should certainly be consulted before making it.

The majority support their action in part by a long quotation from H. R. Rep. No. 1383. It should be noted that the discussion at that point of the report is not addressed to §10(b) but to the reporting and disclosure provisions of Securities Exchange Act of 1934, specifically §§12-14, 16. Section 12 of the Act, 15 U. S. C. §78*l*, requires the registration of securities traded on a stock exchange and of certain other widely held securities. Detailed information similar to that required by the 1933 Act has to be filed with the Commission for such registered securities, and this infor-

mation is required by §13, 15 U. S. C. §78m, to be kept "reasonably current" by periodic and other reports filed with the Commission and the stock exchanges. In addition §16(a), 15 U. S. C. §78p(a), requires certain officers, directors and major shareholders to file reports with the Commission and the stock exchanges as to their initial holdings of stock and subsequent changes. Finally, pursuant to §14, 15 U. S. C. §78n, the Commission has promulgated proxy rules setting forth information that must be sent to shareholders prior to their annual or other meetings. See Schedules 14A-14C, 17 C. F. R. §240.14a-101–103.

To encourage compliance with these disclosure and reporting requirements, Congress enacted civil (§18, 15 U. S. C. §78r) and criminal (§32, 15 U. S. C. §78ff) provisions. A close reading of §18 will demonstrate that a plaintiff proceeding under that section (as opposed to §10(b)) does not have to show that the misleading statement was issued by a person [or corporation] who engaged or participated in a securities transaction or even that the misstatement was intended to influence securities transactions as part of some fraudulent scheme. Therefore, the statements in the legislative history applicable to the reporting and disclosure provisions have no bearing on the correct interpretation of §10(b). That section was not meant to be an auxiliary disclosure device or a provision to punish those who issue inaccurate statements in newspapers or documents filed with the Commission *unless* they are fraudulent acts integrally connected with securities transactions. If there is no such connection, investors are relegated to §18 or state law to recover their losses and the Commission must use its other remedies, discussed *infra*.

In discussing Rule 10b-5 Cohen expressed concern which, as a result of the majority opinion, seems to have been well

founded, that Rule 10b-5 would be given an "unwarranted" extension. In "Truth in Securities Revisited," *op. cit. supra,* at 1366, he said:

> "Nor is it clear that Rule 10b-5 will not be read as providing an alternative remedy (alternative to the considerably more limited express remedy of section 18) for false or misleading statements in filing under sections 12 and 13. One might regard these as surprising and even unwarranted extensions of Congress's terse proscription of 'any manipulative or deceptive device or contrivance' in section 10(b) and yet not care to predict confidently that the momentum of decisions will not carry this far."
>
> • • • • •
>
> " . . . I firmly believe that whatever inadequacy is found in §18, as the basic civil liability provision applicable to the continuous disclosure system, ought to be taken care of by direct amendment of the section itself, not by resorting to the broader, vaguer, but (in my view) otherwise directed provisions of Rule 10b-5. I believe that the problem of misrepresentation in a registrant's (issuer's) required filings is quite distinct from the problem of fraud or misrepresentation by a purchaser or seller of a security (even though the two areas sometimes overlap), and that more mischief than good is likely to come from confusing them or treating them as interchangeable."
>
> (Cohen, *op. cit. supra* at 1370, n. 89)

The majority opinion must also be considered in light of its overall impact before a decision can be reached as to its advisability (assuming that the power to interpret §10(b) is as unlimited as the majority apparently believe).

It should be realized that the construction given 10b-5 will turn it into a comprehensive regulatory provision applicable to all corporate and individual statements, but without any of the detailed standards necessary to implement such a program. The Commission is presently arguing that 10b-5 is applicable to all corporate statements disseminated to the public or filed with the Commission. See *S. E. C.* v. *Great American Industries, Inc.*, 259 F. Supp. 99 (S. D. N. Y. 1966), appeal pending; *Heit* v. *Weitzen*, 260 F. Supp. 598 (S. D. N. Y. 1966), *Howard* v. *Levine*, 262 F. Supp. 643 (S. D. N. Y. 1965), consolidated appeal pending sub nom. *Heit* v. *Weitzen* (*amicus curiae*). The majority opinion appears to approve of the Commission's position without reservation.

The Commission's arsenal of weapons for fighting misleading statements has certainly not been shown to be insufficient for it to carry out the tasks that Congress assigned to it. Rule 10b-5 remains a potent method of proceeding against fraudulent schemes which involve securities transactions for both the Commission and private investors. The Commission can also obtain injunctions to enforce compliance with the disclosure and other provisions of the Securities Exchange Act (§21, 15 U. S. C. §78u), and stiff criminal penalties are provided for failure to comply with the statute or rules promulgated thereunder (§32, U. S. C. §78ff). The Commission can suspend trading for successive periods of 10 days in any security which it feels is being affected by misleading press releases (§§15(c)(5), 19(a)(4), 15 U. S. C. §§78o(c)(5), 78s(a)(4)). For an example of the effective use of this latter power see SEC Sec. Exch. Act Rel. No. 7741 (Nov. 4, 1965) relating to suspension in trading of Belock Instrument Corporation, a defendant in *Heit* v. *Weitzen, supra.* Finally, when faced

with the repeated issuance of misleading press releases, the courts can without more proof draw the inference that they were purposefully distributed to affect the price of the issuer's securities, justifying injunctive relief under 10b-5 and possibly other remedies. See *SEC* v. *Electrogen Industries, Inc.*, 68 Civ. 23 (EDNY, Feb. 26, 1968). In any event if the Commission feels that its arsenal should be augmented, Congress not the courts is the proper forum for its arguments.

Other Judicial Interpretation

The construction given the "in connection" clause by the District Court has been followed in the many cases that have considered the point. See *SEC* v. *North American Research & Development Corp.*, 1968 CCH Fed. Sec. L. Rep. ¶92,149 (SDNY Feb. 8, 1968); *Puharich* v. *Borders Electronics Co., Inc.*, 1968 Fed. Sec. L. Rep. ¶92,141 (SDNY Jan. 24, 1968); *Howard* v. *Levine*, 262 F. Supp. 643 (SDNY 1965), appeal pending; *Gann* v. *BernzOmatic*, 262 F. Supp. 301 (SDNY 1966) (dictum); *Heit* v. *Weitzen*, 260 F. Supp. 598 (SDNY 1966), appeal pending.

It is of course true, as the Commission points out, that the "in connection" clause has been given a broad construction by the courts in line with the remedial nature of securities legislation (see *SEC* v. *Capital Gains Bureau*, 375 U. S. 180, 195 (1965); cf. *Tcherepnin* v. *Knight*, 389 U. S. 332, 336 (1967)), but no case supports the Commission's position that it is in effect meaningless. The cases to date have involved defendants who if not actually purchasing or selling securities at least participated in a direct manner in a securities fraud.[6] Thus one who conspires with or aids and abets another in the fraudulent purchase or sale

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6 In two cases, on motions to dismiss, two courts have permitted 10b-5 actions to continue where defendants were not alleged to be intimately

of securities may have the needed connection. See *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (SDNY 1963) (Defendant Exchange and its officers allegedly aided and abetted an illegal distribution of stock by its failure to take necessary disciplinary actions against abusive conduct and practices of its employees of which they knew or should have known. Held: sufficient allegation of fraud under 10b-5); *Brennan* v. *Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N. D. Indiana 1966) (Defendant corporation allegedly aided and abetted an alleged violation of 10b-5 by its brokerage firm because of its failure to report the improper activities of said firm to the proper authorities. Held: cause of action stated under 10b-5).

Similarly, corporate officers or directors may be liable for causing their corporation to engage in securities transactions. See *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2d Cir. 1964) (Corporation allegedly defrauded into issuing securities to its President through the failure or refusal of some of its directors fully to disclose to the remaining directors material facts concerning the transactions or the financial condition of the company); *Bredehoeft* v. *Cornell*, 260 F. Supp. 557 (D. Ore. 1966) (Plaintiff induced to sell his stock to the corporation for less than its true value because the defendants, stockholders and directors of the company fraudulently concealed material facts); *New Park Mining Co.* v. *Cranmer*, 225 F. Supp. 261 (SDNY 1963) (Defendants caused plaintiff corporations, of which they were officers, to issue stock for property which was worth much less than the stock); cf. *H. L. Green Co.* v. *Childree*,

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connected with a purchase or sale of securities. *Miller* v. *Bargain City, U. S. A.*, 229 F. Supp. 33 (E. D. Pa. 1964); *Fischer* v. *Kletz*, 266 F. Supp. 180 (SDNY 1967). But in both cases the courts recognized that further factual and legal development was necessary for the proper resolution of the issue.

185 F. Supp. 95 (SDNY 1960) (Accountants allegedly induced corporation to go through with a merger (a securities transaction) by preparing false financial statements and making other misrepresentations).

A corporation may itself violate Rule 10b-5 if it engages in fraudulent activities in connection with a merger or other transaction involving securities. See *Freed* v. *Szabo Food Service, Inc.*, '61-'64 CCH Fed. Sec. L. Rep. ¶91,317 (N. D. Ill. 1964) (Corporation, as part of a campaign to boost the value of its stock to achieve stockholder approval of a merger, deliberately issued statements misrepresenting future combined earnings. The price went up and the shareholders were impressed with this indication of the opinion of the financial community as to the proposed merger. The plaintiffs were held to have stated a cause of action under 10b-5 because they allegedly bought stock in the combined company on the strength of those misrepresentations.); cf. *Vine* v. *Beneficial Finance Co.*, 374 F. 2d 627 (2d Cir. 1967) (Corporation fraudulently arranged a merger so that one class of shareholders would receive much less than the other class which was comprised of officers and directors. While the alleged fraudulent acts were committed before plaintiff sold his stock (he had not at the time of suit), he was about to be forced to sell his part of a single fraudulent scheme.).

Another series of decisions involve a broker, dealer or financial institution which fraudulently induced plaintiff's purchase or sale. See *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (SDNY 1965) (Plaintiffs retained stock in a company solely because a broker misrepresented or failed to disclose certain material facts.); *Glickman* v. *Schweickart & Co.*, 242 F. Supp. 670 (SDNY 1965) (Broker induced plaintiff to purchase some stock and to finance the purchase through a factor without disclosing material facts concern-

ing the risks of such a procedure.); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (SDNY 1964) (Trust company alleged to be a participant in a fraudulent scheme whereby loans were made to plaintiff by a factor who converted the stock when it was pledged as collateral for the loan.); *Meisel* v. *North Jersey Trust Co.*, 218 F. Supp. 274 (SDNY 1963) (same); *Lorenz* v. *Watson*, 258 F. Supp. 724 (E. D. Pa. 1966) (Brokerage house liable to plaintiff if it failed to supervise adequately one of its employees who allegedly was guilty of "churning" or excessive turnover in plaintiff's account.). See also §§9(a)(4), 15(c)(1), (2), 15 U. S. C. §§78i(a)(4); 78o(c)(1), (2). In all of the above cases the defendants, unlike the defendant here, were clearly participants in a securities transaction and were guilty of or responsible for deceptive activities of which the securities transaction was an integral part.

The Injunction Remedy

The remedy of a permanent injunction against the company, its offiicers and agents, the issuance of which the majority leaves to the discretion of the trial court, would not only be inappropriate but would be destructive of fundamental rights—"inappropriate" because based upon one "too-gloomy" press release on April 12, 1964, with no proof of continuing gloominess thereafter. The issuance of any injunction over four years after the alleged violation would place a large company and its many executive employees under the possibility, without even a *Miranda* warning, that anything they say may be held against them and place them under the danger of criminal sanctions; "destructive of fundamental rights" because the restraint constitutes not "double" jeopardy but "perpetual" jeopardy. If, as the majority say, the test of the news release is its impact on the "reasonable" investor (although they indicate that the un-

reasonable speculator, too, comes under their solicitous wing) to avoid the danger of injunction violation it would be necessary to seek a declaratory judgment from the courts (both trial and appellate because following the majority, Rule 52(a) would no longer apply). As to the sufficiency of the news release, the first issue would be what constitutes a "reasonable" investor. After the court had made a preliminary finding of reasonableness, these investors could then testify as to the impact that the proposed release would have on them. Query, as to whether twelve witnesses (akin to a jury) should be required—and would a seven-to-five count be acceptable or would ten-to-two more accurately reflect public opinion? Other situations and problems of an equally *reductio ad absurdum* character can easily be conjured up. They would only point more directly to the conclusion that an injunction here would not only violate fundamental legal principles which for centuries have restricted the injunctive grant but would not be justified by any sufficient factual showing in this case. No clear and present danger, no continuing wrongful acts and no likelihood thereof are to be found in the record before this court.

Crawford, Clayton and Coates

Since I believe that the findings of the trial court are solidly founded and should be respected, I agree with its decision as to Crawford and Clayton. I agree with the majority as to Coates because for all practical purposes the information had not become public at the time of his purchase order.

Conclusion

In summary, the most disturbing aspect of the majority opinion is its utterly unrealistic approach to the problem

of the corporate press release. If corporations were literally to follow its implications, every press release would have to have the same SEC clearance as a prospectus. Even this procedure would not suffice if future events should prove the facts to have been over or understated—or too gloomy or optimistic—because the courts will always be ready and available to substitute their judgment for that of the business executives responsible therefor. But vulnerable as the news release may be, what of the many daily developments in the Research and Development departments of giant corporations. When and how are promising results to be disclosed. If they are not disclosed, the corporation is concealing information; if disclosed and hoped-for results do not materialize, there will always be those with the advantage of hindsight to brand them as false or misleading. Nor is it consonant with reality to suggest, as does the majority, that corporate executives may be motivated in accepting employment by the opportunity to make "secret corporate compensation . . . derived at the expense of the uninformed public." Such thoughts can only arise from unfounded speculative imagination. And finally there is the sardonic anomaly that the very members of society which Congress has charged the SEC with protecting, i.e., the stockholders, will be the real victims of its misdirected zeal. May the Future, the Congress or possibly the SEC itself be able to bring some semblance of order by means of workable rules and regulations in this field so that the corporations and their stockholders may not be subjected to countless lawsuits at the whim of every purchaser, seller or potential purchaser who may claim he would have acted or refrained from acting had a news release been more comprehensive, less comprehensive or had it been adequately published in the news media of the 50 States.

APPENDIX A

Judgment of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of August one thousand nine hundred and sixty-eight.

Present:

Hon. J. EDWARD LUMBARD, Chief Judge,
Hon. STERRY R. WATERMAN,
Hon. LEONARD P. MOORE,
Hon. HENRY J. FRIENDLY,
Hon. J. JOSEPH SMITH,
Hon. IRVING R. KAUFMAN,
Hon. PAUL R. HAYS,
Hon. ROBERT P. ANDERSON,
Hon. WILFRED FEINBERG,
Circuit Judges.

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellant,

v.

TEXAS GULF SULPHUR Co., *et al.*,
Defendants-Appellees,

DAVID M. CRAWFORD and RICHARD H. CLAYTON,
Defendants-Appellants.

Appendix A

Judgment of the United States Court of Appeals for the Second Circuit

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order and judgment of said District Court be and they hereby are affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings below consistent with the opinion of this court.

A. Daniel Fusaro
Clerk

By Vincent A. Carlin
Chief Deputy Clerk

APPENDIX B

Constitutional Provision, Statutes and Rules Involved

Fifth Amendment to the Constitution of the United States:

> "No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

Securities Exchange Act of 1934, §10(b), 48 Stat. 891, 15 U.S.C. §78j:

> "Sec. 10. Regulation of the Use of Manipulative and Deceptive Devices
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any securities exchange—
>
> ". . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as neces-

sary or appropriate in the public interest or for the protection of investors."

Securities Exchange Act of 1934, §21(e), 48 Stat. 900, 15 U.S.C. §78u(e):

"(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States, the District Court of the United States for the District of Columbia, or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title."

Rule 10b-5, 17 CFR 240.10b-5: "Employment of Manipulative and Deceptive Devices":

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

Appendix B

Constitutional Provision, Statutes and Rules Involved

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Rule 12b-2(j), 17 C.F.R. 240.12b-2(j): "Definitions":

"Unless the context otherwise requires, the following terms, when used in the rules contained in this regulation or in Regulation 13A or 15D or in the forms for statements and reports filed pursuant to sections 12, 13 or 15(d) of the act, shall have the respective meanings indicated in this rule:

(j) *Material.* The term 'material', when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered."

APPENDIX C

Excerpts from Record

Pre-Trial Order No. 6

* * *

The parties stipulated the following facts for the purposes of this action only:

* * *

B.

(4792) (1) On February 20, 1964, pursuant to the company's restricted stock option plan, the directors of Texas Gulf granted to certain of the defendants options to purchase shares of the company's stock at a price of 23-13/16 per share as shown by the following chart:

Defendant	*Optioned Shares*
Stephens	12,800
Fogarty	7,300
Mollison	4,300
Kline	4,300
Holyk	2,000

The price at which the options are exercisable was measured by the mean price of the stock on the New York Stock Exchange on February 20, 1964.

(2) The options were granted by the directors' incentive stock option committee consisting of John H. Hill, Leslie M. Cassidy and the defendant Coates, subject to approval by the Board of Directors of certain amendments to the stock option plan. The action of the directors' committee was approved on the same day by the full Board of Directors. Those directors who were granted options abstained from voting. Mr. Cassidy, however, was not present at either the option committee meeting or the Board of Directors meeting on February 20.

* * *

Appendix C—Excerpts from Record

Pre-Trial Order No. 6

John A. Hill, for Plaintiff—Direct

(4815) 12. On July 15, 1965, the Board of Directors of Texas Gulf, by unanimous vote, determined and declared that the stock options granted to Richard D. Mollison, Harold B. Kline, and Walter Holyk on February 20, 1964, "have been beneficial" to Texas Gulf "and will continue to further the growth and development of the company, to retain in its employ persons of training, experience and ability, to encourage the sense of proprietorship of such persons and to stimulate their active interest in the development and financial success of the company."

* * *

(118) JOHN A. HILL, called as a witness by the plaintiff, being first duly sworn, testified as follows:

* * *

(119) *Direct examination by Mr. Joseph*:

Q. Mr. Hill, what is your occupation? A. I am chairman of the board of the Air Reduction Company.

Q. Do you serve as a director of any other publicly held company at this time? A. I do, for the Marine Midland Grace Trust Company and the Marine Midland Corporation.

Q. Were you at one time, Mr. Hill, a director of the Texas Gulf Sulphur Company? A. I was.

Q. What was the period of time covered by your position? A. The latter part of 1958 until the latter part of 1965.

Q. Could you describe for the Court, Mr. Hill, very generally what your functions as a director of Texas Gulf Sulphur Company were during this period? (120) A. My functions were to consult with the management in the board meetings and sometimes outside of board meetings, to give advice on matters within my knowledge and to generally conduct myself as a director.

Appendix C—Excerpts from Record

John A. Hill, for Plaintiff—Direct

Q. I take it you made an attempt generally to keep abreast of the corporate developments concerning the company? A. That is correct.

Q. Mr. Hill, did you not, as you were a director of Texas Gulf Sulphur Company, serve on the directors' committee to administer the company's restricted stock option plan? A. I did.

Q. And you so served during February of 1964? A. I did.

Q. Could you describe for the Court your general function as a member of this committee? A. The general function as a member of this committee was to examine into recommendations made by the principal officers of the company with respect to stock options, and I would presume we would take independent action, but that was not called for as we were satisfied with the identity and the (121) amounts awarded to the recipients of the stock options.

The Court: You said you would get recommendations from the officers?

The Witness: The chief executive officer principally.

The Court: Who would that be?

The Witness: That would be Mr. Stephens, and perhaps Mr. Fogarty, Dr. Fogarty.

Q. And these gentlemen would generally make recommendations as to the persons who should receive options and the amount that should be received by each? A. They would.

Q. And the prices? A. Yes.

Q. Mr. Hill, what was your understanding during this time of the actual purpose of Texas Gulf's restricted stock option incentive plan? A. Well, the purpose was to give

certain people an opportunity to acquire a proprietary interest in the company.

Q. Of course, they could do that by going out in the market and buying stock, could they not? (122) A. They might have, on an advantageous basis, yes.

Q. Did you understand that a function of the plan was to provide an incentive for these executives? A. Yes.

Q. To improve the company and hopefully increase the market value of its stock? A. That is correct.

Q. And, Mr. Hill, in acting on the recommendations that the committee would receive from the chief executives of the company in this regard, what factors were generally considered by yourself in terms of whether to approve, disapprove or modify such recommendations? A. Well, we discussed each individual who was recommended and satisfied ourselves that these were people whom the company wanted to keep and who had a good future with the company.

Q. Were you at all concerned with the market value of Texas Gulf stock at the time you were passing upon such recommendations? A. We were not concerned with the market value of the stock with respect to the 1961 stock options. There was some concern in the interim between '61 and (123) '64 when the market value of the stock went down from 23 or 24, at which price options were granted in '61, to 11 in the interim. It was felt that it would not be appropriate to issue stock options at those lower prices.

Q. During what period are you speaking? A. During the period from 1961 until some time probably in 1963 when the stock recovered to the prices at which the options were granted in 1961.

Q. Now, in February—

The Court: As I understand your point, you didn't think it appropriate to issue stock options at

a price lower than those you had already issued in '61.

The Witness: That is correct.

The Court: All right.

Q. I take it that by February of 1964 the market price had again reached that 1961 point. A. Yes. That is my recollection.

Q. And in February, 1964, February 20th to be precise, you attended, did you not, a meeting of the Stock Option Committee to pass upon the granting of options on that date? (124) A. That is right.

Q. Did you entertain at that time any opinion as to the future course of the market price of Texas Gulf Sulphur stock? A. No.

Q. Do I understand correctly that the price at which the options were granted at that time were keyed to the then existing price of the stock on the New York Stock Exchange? A. That's right. If it is a restricted stock option, then it had to be keyed to the price.

Q. And the price on the Stock Exchange is required, under the Federal tax law, is it not, to be a fair market price? A. So I understand.

Q. Then I take it you would consider, at any time in granting options, whether the New York Stock Exchange price was a fair market price. A. I think that it would be very unusual to take something else other than the Stock Exchange price as the fair market price.

Q. You would generally assume that that is the fair market price, is that correct? A. That is right.

* * *

(125) Q. Now, Mr. Hill, I take it that you voted in favor of granting these options on February 20. A. I did.

Q. Were you aware on that day of the results of Texas Gulf's drilling in Kidd Township, Timmins, Ontario, Canada? A. I was not.

Appendix C—Excerpts from Record

John A. Hill, for Plaintiff—Cross

Q. Did you know that the company was drilling up there? A. Only generally, that exploration was being done on the so-called Canadian Shield. I had no (126) idea of what results, if any, there were.

Q. You didn't know, I take it, that the exploration was necessarily in the Timmins area? A. I had never heard of the Timmins area.

* * *

(128) *Cross-examination by Mr. Marden:*

Q. Mr. Hill, there are a number of employees of the company who were granted stock options on February 20, were they not? A. That's right.

Q. Some 24 or so? A. Yes.

* * *

Q. The stock options that were granted by your committee on February 20, 1964, were they keyed to salaries? Did salary have anything to do with the number of shares that were allotted? A. Yes, they were keyed to salaries.

Q. A certain formula was used? A. Yes, a formula was used.

(129) Q. Was there any discussion at that time of the pendency of legislation in Congress that might affect restricted stock options? A. There was.

Q. Was that one of the reasons that the committee acted at that time? A. It was.

Q. Who was chairman of the directors' Committee on Stock Options? A. Mr. Coates.

Q. Francis Coates? A. Yes.

Q. As I understand it, only two series of options have been granted under the stock option plan approved by the stockholders of Texas Gulf Sulphur Company, is that correct? A. That is correct.

Q. 1961? A. '61.

Q. And again in 1964? A. '64.

Appendix C—Excerpts from Record

John A. Hill, for Plaintiff—Cross

Francis G. Coates, for Plaintiff—Direct

Q. Did you participate in discussions between 1961 and 1964 with respect to stock options? A. I don't recollect that I did. I may have. (130) I don't recollect that we had a meeting of the committee.

Q. You mentioned that there was some concern about granting additional options until the market price of the stock reached the same price as had been used for the options in '61. Do you remember that? A. Generally, yes.

Q. Do you know whether Mr. Stephens participated in these discussions? A. No, I don't recall.

Q. But you do recall that there was a discussion about it and some concern about it? A. Yes.

* * *

(132) FRANCIS G. COATES, called as a witness by the plaintiff, having first been duly sworn, testified as follows:

Direct examination by Mr. Joseph:

Q. Mr. Coates, what is your occupation, sir? A. I am a lawyer.

Q. How long have you been practicing law? A. Since June, 1920.

Q. Do you practice in Texas, Mr. Coates? A. Yes.

Q. Your home is in Houston? A. My home is Houston.

Q. Do you serve as a director of any publicly held corporations, Mr. Coates? (133) A. Texas Gulf Sulphur Company.

* * *

(134) Q. On what committees of the board of directors do you serve, Mr. Coates?

The Court: What time are you talking about now? The present time or 1964?

Q. Let's talk about 1964, Mr. Coates. On what committees of the board of directors of the company did you

serve during that period? A. The Executive Compensation Committee and the Stock Option Committee.

* * *

(135) Q. And what, sir, was your function as a member of the Stock Option Committee? A. Well, my firm participated in drawing the stock option plan that we still have in effect, with some amendments to conform to the 1964 changes in stock options. Our function was to—

Q. You are speaking now of the committee's function or your firm's function? A. Well, the committee's function was to consider who were those who were regarded as key men and to determine, more or less on the formula basis, how many shares of stock each should get an option for.

Q. You were the chairman of that committee during this period, were you not, sir? (136) A. Yes.

Q. Did you want to explain that answer, sir? A. My counsel has asked me to remember that I am a witness and not to volunteer.

Q. I see. I will continue to ask you specific questions, then.

Did the committee, during any period of time that you served on the committee, meet on its own initiative or did it generally meet at the suggestion of the executives of the company? A. It met at the suggestion of the chairman, and I was the chairman.

Q. And it was your suggestion that the committee meet in February of 1964? A. It was.

Q. When did you reach that determination, sir? A. Oh, I had been talking to members of the committee and, likewise, members of the board, about granting some additional stock options, because the 1961 stock options were granted to provide incentive, and instead of providing incentive they, by reason of the stock dropping, provided nothing of that sort at all.

Appendix C—Excerpts from Record

Francis G. Coates, for Plaintiff—Direct

As Mr. Hill testified, the stock went down to (137) 11⅛ in 1962, and I thought that the stock was underpriced at that, and what the members of the committee were doing was keeping pretty well abreast of the market to determine when the stock recovered sufficiently so that it would be fair to grant additional stock options.

Q. With whom did you have these discussions, Mr. Coates? A. With both Mr. Cassidy and Mr. Hill, who were members of the Stock Option Committee, and I believe every other director on the board from time to time.

Q. Was the committee comprised entirely of yourself and Messrs. Hill and Cassidy? A. That's right.

Q. Well, do you recall approximately when you decided to have a meeting of the Committee? A. No. It was, of course, some time in advance of the meeting. But—

Q. The meeting on February 20th, I take it, was a regular board of directors meeting day? A. It was either the day before or the morning of our February, 1964, directors meeting.

Q. Well, did you, yourself, personally contact your fellow members of the committee and advise them of your wish to hold a meeting of the committee? (138) A. I called the meeting, and by phoning Hill, who was in New York, and—

Q. And where were you, sir? Were you in Texas at the time? A. I was in Texas at the time. And I likewise phoned Mr. Cassidy, who was in Florida, and was advised that he couldn't attend the meeting.

Q. Did you discuss your intentions of the business that would be transacted at the meeting with Mr. Cassidy? A. I did. Not at great length, but he was acquainted with what the meeting was about.

Q. By the time that you made the telephone calls, sir, had you been presented with a specific recommendation from any of the executives as to who should receive options

and how many they should receive? A. I don't believe that the committee got to that until a few days before our meeting. I did know that Mr. Stephens, the top executive, did want to add additional men to the group who got the 1961 options.

Q. Do you recall whether Mr. Stephens at any time prior to the meeting itself presented you with a list of specific recommendations? A. He did, at my request.

Q. And when was that, sir? (139) A. Some time before the meeting.

Q. Several days or several weeks? Do you have any recollection at all in this regard? A. No, no specific recollection. These same men had been considered by the Executive Compensation Committee, so I as a committeeman had a great deal of information about them.

Q. I see.

What was your understanding, sir, of the function of the company's stock option plan itself that your firm had drafted? A. To provide initiative by giving the employees, and particularly the key employees, a financial stake in the corporation.

Q. Was it also to provide initiative in the sense that they would hopefully further the growth of the company and also hopefully and correspondingly cause the market price of its stock to increase?

The Court: That is sort of a multi-barreled question, it seems to me.

The purpose was, naturally, you thought by giving them a stake in the company they would work harder.

The Witness: We did.

(140) The Court: And if they worked harder, all things being equal, the company's profit might increase.

Appendix C—Excerpts from Record

Francis G. Coates, for Plaintiff—Direct

The Witness: That was certainly our intention.

The Court: And if they increased, it might be the market price of the stock would go up.

The Witness: That's right. If they did their job a little bit better than usual.

* * *

By Mr. Joseph:

Q. When did you come to New York City, Mr. Coates, in order to attend the meeting on February 20th? A. I don't recall.

Q. But the meeting was held in New York City, I take it? A. I beg your pardon?

Q. The meeting was held in New York? A. It was held in New York City, yes.

Q. And who was present at the meeting? A. At the meeting of the Stock Option Committee?

Q. Yes, sir. A. Mr. Hill and I.

Q. And did you, in effect, have the proxy of (141) Mr. Cassidy? A. Well, I knew what I had been told by him, what his ideas were, about the grant of these options.

Q. And on that day the committee, as I understand it, determined to grant options to certain key executives and did in fact grant the options. A. I have never thought that the legal effect was that the committee granted the options. The committee recommended to the board that the options be granted.

Q. Did the board meet on that day or shortly thereafter to— A. It met either the next morning or later on the same day.

Q. And it ratified the decision of your committee to— A. It did.

Q. —grant these options?

On that day, Mr. Coates, were you aware of the results of Texas Gulf's drilling in Kidd Township, Ontario, Canada? A. I was not.

Appendix C—Excerpts from Record

Francis G. Coates, for Plaintiff—Cross

Q. Did you know the company was exploring in the Timmins area? (142) A. Would you repeat that question?

Q. Did you know, sir, that the company at that time was exploring in the area of Timmins? A. No.

Q. Did you know that it was exploring in Canada? A. I knew it was exploring the Canadian Shield.

Q. But you didn't know anything specifically about Timmins or Kidd Township? A. I did not. I had never heard of Timmins.

* * *

(176) *Cross-examination by Mr. Marden:*

* * *

(178) Q. In the course of that exploration, take the Canadian Shield, did you know that there was considerable diamond drilling by the company on the Canadian Shield? A. No.

Q. Did you know that in various of the exploration ventures of Texas Gulf Sulphur there had been diamond drilling for minerals? A. Oh, yes.

Q. When directors' meetings were held, was it customary for the management to report to the board of directors each time a new hole had been drilled in these exploration programs? A. It was not and it is not customary at any mining company that I know about. What the directors do is to appropriate so much money for exploration and then management decides where and how the money is going to be spent.

Q. And I suppose that directors would hear about it when and if a particular venture proved out to be a (179) promising or probably a successful one? A. Yes. They would hear about it usually just before the public would hear about it.

Q. You were chairman, were you not, of the stock option committee in February of 1964? A. I was.

Appendix C—Excerpts from Record

Francis G. Coates, for Plaintiff—Cross

Q. And you had been chairman since 1961, as I recall? A. Yes.

Q. Was it customary for officers and employees of the company to wait on that committee and tell them all the facts that they knew about the company while the option committee was considering whether or not to grant options? A. No. I tried to be a good director and to keep currently informed.

Q. If you had known, Mr. Coates, on February 20, 1964, that there had been a single hole drilled at Timmins producing a promising core mith mineralization of zinc, copper and silver, would that have influenced you not to vote for options on that day? A. It would not.

Q. Tell us why not. A. Well, Texas Gulf Sulphur Company practically (180) the entire time that I have been on the board has had widely scattered exploration activities going on all the time. I wouldn't have thought there was anything unusal about having a promising core.

Another thing that happened just a few months before the Timmins discovery, we had a beautiful core in Western Canada in a sour gas well.

Mr. Marden: No further questions, your Honor.

By the Court:

Q. One thing on this option committee. Do you interview any of these employees to whom stock options are voted by you? A. No, your Honor, because I have been quite familiar with the key personnel since 1952. At that time I drafted a supplement to the retirement income plan and studied the salary schedules and the general performance of these men, and I—

Q. You studied their performance from the records of the company and by what the principal officers tell you about them? A. Yes.

Appendix C—Excerpts from Record

Francis G. Coates, for Plaintiff—Cross

Harold B. Kline, for Plaintiff—Direct

Q. You don't interview them, you don't talk to them or anything like that? A. Not about their compensation, no, sir.

* * *

(243) HAROLD B. KLINE, a defendant, called by the plaintiff, being first duly sworn, testified as follows:

Direct examination by Mr. Joseph:

Q. Mr. Kline, what is your profession, sir? (244) A. I am a lawyer.

Q. By whom are you employed? A. Texas Gulf Sulphur Company.

Q. How long have you been employed by that company? A. Since November, 1958.

Q. Would you please outline generally for the Court your professional background as a lawyer prior to becoming associated with that company? A. Well, I graduated from the Harvard Law School in 1935 and was associated for six years with a downtown office in this city, Root, Clark, Buckner & Ballentine.

I served a year then in the Department of Justice in work related to the war effort, and entered military service in 1942. I served for four and a half years.

Upon my discharge from the Army I opened up my own law office in St. Louis, Missouri, and was a part-time teacher at the Law School of Washington University. I served for two years there as head counsel of the Federal Reserve Bank in St. Louis.

In 1953 I joined the legal staff of General Electric Company, and served in various legal capacities with that company until 1958, when I joined Texas Gulf Sulphur Company.

(245) Q. In what capacity did you join Texas Gulf? A. I was employed as assistant to the president and per-

formed administrative duties largely until I was named secretary of the company in January of 1961.

Q. Would you continue to outline your various functions with Texas Gulf since that time? A. Well, I served as corporate secretary from that time on and was elected vice-president of the company in 1963, and served in those two capacities until February 20, 1964.

However, late in January of 1964 our senior counsel passed away and within several days I also became general counsel, serving as vice-president, general counsel and secretary until February 20, 1964, when I gave up my duties as corporate secretary.

Since February 20, 1964, I have continued as general counsel of the company, and a vice-president.

Q. You became general counsel prior to February 20, 1964? A. Yes, I did, that's correct.

Q. Do you recall the date of your predecessor's death? A. The date my predecessor's death was, I think, January 23rd, and I was invited to assume a legal responsibility (246) within a day or so and orally accepted it and I think that the official appointment took place on January 31, 1964.

* * *

Q. Mr. Kline, did you occupy any specific function with respect to the directors' committee to administer the company's stock option plan in February of 1964? A. No special function other than that of corporate secretary.

Q. You acted as corporate secretary on February 20, 1964, when that committee met? A. I did, sir.

Q. Did you exercise any function in that capacity prior to the actual meeting on the morning of February (247) 20th? A. Can you relate your question more specifically to time?

Q. Any time prior to February 20th, did you have anything whatever to do with this coming meeting? A. With the forthcoming meeting of the option committee?

Q. That is correct. A. No, sir.

Q. When were you asked to attend the meeting? A. I was asked by Mr. Frank Coates to attend the meeting and I was asked on the evening of the day before the meeting took place.

Q. And the first thing you actually did, I take it, was to attend the meeting? A. Yes, sir.

(248) Q. And what did you do at that meeting? A. I sat and I made records of the proceedings.

Q. You were one of the individuals granted stock options during that meeting? A. Yes, sir, I was.

Q. Did you do anything other than take notes at the meeting? A. No, sir.

Q. What did you do after the meeting with regard to that committee's function? A. Well, immediately after the meeting I crossed the hall and performed the duties of corporate secretary at the regular monthly meeting of the board of directors, at which time I submitted my resignation and Mr. David M. Crawford was elected my successor as corporate secretary.

I don't think that's quite responsive to what you were getting at. I will be happy to try again, Mr. Joseph, if you will lead me.

Q. Well, I think we can get at it this way, Mr. Kline. I am showing you Plaintiff's Exhibit 6. A. Right.

Q. Which consists of copies of several telegrams. A. Yes, sir.

(249) Q. Sent to the recipients or certain of the recipients of the stock options granted on February 20. Do you recognize those copies? A. Well, I see it is a form telegram that I prepared and dispatched to each optionee who was awarded an option at that meeting, and I did that responsively to the request of Mr. John Hill who was a member of the committee.

Appendix C—Excerpts from Record

Harold B. Kline, for Plaintiff—Direct

Q. And you saw to it then that each person granted options on that day received notification of the granting of the option by a telegram? A. Yes, sir, even including myself. My secretary was diligent and she sent me a copy of the telegram signed by myself, which I received in due course.

Q. I notice that that was addressed to you at your home. A. Yes, sir.

Q. And all of the remaining telegrams were addressed to the homes of the respective optionees. A. Yes, sir.

Q. Do you recall when you received your telegram? A. No, I don't.

(250) Q. Do you recall in what manner you received it? A. I live in an apartment hotel, and it would have been delivered to the lobby and put in my box and I would have picked it up, and once I saw it I would have destroyed it.

Do you recall picking it up? A. No, sir, I don't.

Q. Did the recipients of the stock options on this day, to your knowledge, Mr. Kline, actually receive a document which was in effect an option, a written option? A. To my knowledge, they did not.

Q. Can you tell me what was meant, in the telegram that you were responsible for sending, by the statement—

* * *

(251) "Papers reflecting the grant of the option to you will reach you shortly for your acceptance or other action."

What was meant by that statement? A. Well, that wire was a duplicate of another wire that went out on the occasion of the first grant of options which was made in 1961, and I just gave the communication over to my secretary to see that these matters were taken care of. I didn't really attach any meaning to it at all.

Appendix C—Excerpts from Record

Harold B. Kline, for Plaintiff—Direct

Q. Were you the individual who was responsible for sending out similar telegrams at an earlier time when options were granted? A. Yes, sir. Under the same circumstances Mr. Hill requested me to do that.

Q. Was that in 1961? A. That was in 1961; in May, I think, of 1961.

Q. Following your sending of those telegrams were actual papers in additional to the telegrams sent to the optionees? A. In both cases, in the case of both grants, subsequently papers were sent to some of the optionees. In the case of those optionees who lived outside of New York and who did not come to the office frequently, (252) the communications—I mean the forms were sent to them. But in the case of the people who worked in the New York office and who were there frequently, my secretary would run the individual down, present the papers to him or to them, and would advise me of the consummation of the transaction.

Q. And what were those papers? A. Well, they were forms of option. They were prepared initially by the law firm of Baker, Botts, Shepherd & Coates, and in the case of these options they had a provision on it for acceptance.

Q. You are referring to the '61 options? A. I am talking about the '61 options and also, if you wish me to, the '64 options.

Q. I would like to know whether actual formal written options were given to the optionees in '64. A. Yes. In the case of both grants formal written options were given.

Q. And they were given by you to the optionees? A. My secretary took them over to the optionees for the most part because most of the people either worked in the New York office or were there from time to time. In the case of those people they were physically handed the option forms by my secretary.

Appendix C—Excerpts from Record

Harold B. Kline, for Plaintiff—Direct

(253) On the other hand, for example, in the case of optionees living, for example, in Canada or far away, they would be put in the U.S. mails.

Q. They would be put in the U.S. mails. A. That is correct.

Q. Do you recall how Mr. Crawford was given his option? A. Mr. Crawford was physically tendered his option by my secretary, or by me.

Q. In New York City? A. Yes, sir.

Q. And Dr. Holyk? A. The same way.

Q. Mr. Stephens? A. Same.

Q. Mr. Mollison? A. Same.

Q. And yourself? A. I handed it to myself.

Q. I see. And I take it Dr. Fogarty was also in New York at that time? A. Yes, sir.

Q. He was handed the option physically? A. Correct.

(254) Q. Who prepared the actual forms of the options on this occasion? A. Well, it was sort of a joint effort. I discussed the matter with our outside counsel, and I was responsible for it eventually and I prepared it along the lines I thought appropriate.

Q. This was your Houston counsel? A. Houston counsel on the option forms, yes, sir.

Q. Did they send you any drafts? A. No. I think that what I did was to work with the earlier draft that they had prepared and to check changes with them by telephone.

Q. From New York to Houston. A. Yes.

Q. Did you receive any communication from any of the optionees either in response to these telegrams or in response to the receipt of the option itself? A. There was one reply to the telegram.

Q. From? A. Steve A. Gilmore of Houston, Texas.

Q. Mr. Kline, when did you first become aware of the results of Texas Gulf's drilling in Kidd Township, Ontario,

Appendix C—Excerpts from Record

Harold B. Kline, for Plaintiff—Direct

Canada? (255) A. Well, any particular results, Mr. Joseph, or do you want me to indicate what I discovered from time to time?

Q. I would like to know, first of all, when is the first time you learned that the company was conducting exploration in the Timmins area? A. Well, it was near the midpoint of November, 1963.

Q. What did you learn at that time, sir? A. Well, I was at a luncheon with Mr. Stephens and Dr. Fogarty, and the conversation turned to a favorable development connected with the hole at Timmins, Ontario, and there was a reference to a telephone call which had communicated the word of the favorable development.

Q. What was the next time you learned anything in addition to that? A. I think it was late in February.

Q. After February 20? A. Yes, sir.

Q. But at the time that you attended the meeting of the Stock Option Committee on February 20 at which you, among others, were granted options, you did know, as I understand your testimony, that a promising (256) single drill hole had been drilled in the Timmins area. A. Well, I knew that there had been a drill hole which had intercepted a sulphide body, and I inquired at the time, in the case of the November conversation, whether the sulphide mineralization was similar to that at Baffin Island or similar to that at New Brunswick. Those were other areas with which I was familiar.

Q. And what was the answer to that question? A. My recollection is that it was said that the mineralization involved a combination of the sulphur element with evidence of copper and zinc, which was similar in terms of composition to that at New Brunswick rather than the composition of the mineralogy at Baffin Island where the element sulphur combined with zinc and lead, I believe.

Appendix C—Excerpts from Record

Harold B. Kline, for Plaintiff—Direct

Q. Mr. Kline, when did you first become aware that Texas Gulf Sulphur Company was, subsequent to the drilling of this single drill hole, attempting to acquire additional land in the Timmins area? A. As a matter of fact, Mr. Joseph, I omitted from my earlier account the fact that at that luncheon conversation there was reference to the fact that the (257) drilling had been done right on the boundary of such property as we had and that we would be interested in acquiring more property so that further exploration could be conducted.

Q. Now, at that time, when you heard that conversation, did your functions have anything whatever to do with the acquisition of land? A. No, sir.

Q. And when, if ever, did your functions get into that area? A. Well, the law department has obvious responsibilities in connection with the acquisition of property. As I told you, I was invited to become general counsel on or about January 24, and between January 24 and late February the matter of property acquisition was not referred to me as a problem.

Q. I am sorry. I did not catch the last part of your answer. It was not referred to you? A. No. The first time that I had an opportunity or occasion to consider additional acquisition of property in connection with the Timmins prospect was in late February.

(258) Q. After February 20th. A. Yes, sir.

Q. So that as of February 20, in addition to the existence of the drill hole, you knew simply that the company was interested in acquiring additional land, but you knew of none of the details of the land acquisition? A. That is correct.

Q. On February 20, at the meeting of the Stock Option Committee, Mr. Kline, did you communicate your knowl-

edge or any part of your knowledge as to the drill hole or as to the policy of acquiring land to the two members of the committee who were present that day? A. No, sir.

* * *

Cross-examination by Mr. Marden:

Q. Did it cross your mind, Mr. Kline, that it would be appropriate to refer to that single drill hole at Timmins when you met with the Stock Option Committee on February 20, 1964? A. It did not cross my mind.

Q. Were you trying to conceal it from the (259) Stock Option Committee? A. No, sir.

* * *

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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 897

FRANCIS G. COATES, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A, 3587–3692) is reported at 401 F. 2d 833. The opinion of the district court (Pet. App. B, 1–63) is reported at 258 F. Supp. 262.

JURISDICTION

The judgment of the court of appeals was entered on August 13, 1968. Petitioner filed a petition for rehearing on September 20, 1968, which was denied on October 7, 1968. The petition for a writ of certiorari

was filed on January 3, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder prohibit a director who knows corporate news which is of great importance to persons trading in the corporation's securities, and which is announced at a special press conference called by the corporation, from purchasing shares from stockholders of the corporation immediately after that announcement but prior to publication of the announcement in any news medium of widespread circulation.

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b–5 of the Commission, 17 CFR 240.10b–5, are set out at pages 3–4 of the petition.

STATEMENT

The court of appeals, sitting *en banc,* unanimously held that petitioner had violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder when he telephoned his stockbroker to purchase stock of Texas Gulf Sulphur Company (hereafter "Texas Gulf"), of which petitioner was a director, on the basis of highly important corporate information contained in a press release just handed to representatives of the news media at a special press conference, which information petitioner "could not reasonably have expected * * * to have been dissemi-

nated when he placed his order * * *" (Pet. App. A, 3622).

This action arises out of Texas Gulf's discovery of a large deposit of base and rare metals on land located near Timmins, Ontario, Canada. Following aerial and ground geophysical surveys, drilling was commenced on November 8, 1963, and was suspended four days later (Pet. App. A, 3596). From November 13, 1963, to March 30, 1964, drilling remained suspended while Texas Gulf purchased most of the outstanding interests in the land (Pet. App. A, 3596–3597; Pet. App. B, 8–9). Drilling was resumed on March 31, 1964 (Pet. App. A, 3597). On April 16, 1964, Texas Gulf held a special press conference to issue a release announcing that it had "made a major strike of zinc, copper and silver * * *" (Pet. App. B, 40–41). Neither the accuracy of this release nor the importance of this discovery to Texas Gulf is questioned.

1. THE COMMISSION'S COMPLAINT

On April 19, 1965, the Commission filed a complaint (R. 2851–2885) in the district court alleging that, during the period after the initial suspension of drilling and before the information contained in the April 16 press release became available to the public, thirteen officers, directors and employees of Texas Gulf, including petitioner, had each committed one or more of the following violations of Section 10(b) and Rule 10b–5:

> 1. Purchased Texas Gulf common stock or calls on that stock on the basis of the results of the drilling without appropriate disclosure.

2. Divulged that information to friends, relatives or business associates for use in their purchases of Texas Gulf stock or calls, without appropriate disclosure, or recommended on the basis of such inside information that they purchase Texas Gulf securities.

3. Accepted stock options from Texas Gulf with knowledge of this information, which had been withheld from the directors of Texas Gulf. ~~without appropriate disclosure.~~

It also alleged that Texas Gulf had violated Section 10(b) and Rule 10b–5 by the issuance of a false and misleading press release about the metal deposit on April 12, 1964.

The complaint requested that the defendants be permanently enjoined from future similar violations of Section 10(b) and Rule 10b–5; that the individual defendants who had violated those provisions by purchasing Texas Gulf stock or calls be required to offer rescission to the sellers; that those who had divulged such information be required to offer restitution to stockholders who had sold Texas Gulf securities to the recipients of the information; and that stock options accepted unlawfully be rescinded (R. 2883–2885).

2. THE EVIDENCE AS TO PETITIONER

The trial was limited to the issue whether the defendants had violated Section 10(b) and Rule 10b–5, and the question of remedies was left for a further hearing (Pet. App. B, 1).

Petitioner, a senior partner in a large law firm in Houston, Texas, that represents Texas Gulf, had been

a director of the corporation for some 15 years (R. 132–133). He is also the trustee of four trusts for his children (R. 153). Prior to April 13, 1964, he had no knowledge of the results of Texas Gulf's drilling near Timmins (R. 144).

By April 11, 1964, rumors that Texas Gulf had made an ore discovery, which had previously circulated in Canada, appeared in the New York press (R. 99). Texas Gulf then decided to issue a press release on the subject (R. 1132–1138). The release was issued on April 12 and appeared in the morning newspapers on the following day (Pet. App. B, 49). The release labeled the rumors as "exaggerate[d]," "without factual basis" and "unreliable"; it further stated that "[t]he drilling done to date has not been conclusive * * *" (Pet. App. B, 50–51). It promised that, when sufficient drilling was completed, "TGS will issue a definite statement to its stockholders and to the public * * *" (Pet. App. B, 51). Prior to April 15, petitioner's knowledge of the exploration results was limited to press reports of this release (R. 144–145).

On the afternoon of April 15, the top management of Texas Gulf decided to hold a press conference the next morning, following a regularly scheduled meeting of the board of directors, to announce the discovery (R. 1158–1159). This method of announcing the discovery was chosen "to get the information to the most stockholders as quickly as it was possible," a press conference being "the best media [sic] to get maximum coverage to everyone at the same time" (R. 1161–1162).

Petitioner arrived in New York on April 15 for the directors' meeting (R. 145–146). He went to Texas Gulf's offices and was shown a draft of the press release to be issued the next day and the list of representatives of major newspapers, magazines and news services that had been invited to the press conference (R. 146–147). He believed that the announcement would result in an increase in the market price of Texas Gulf stock (R. 157).

On the morning of April 16 an article about Texas Gulf's discovery appeared in *The Northern Miner,* a weekly Canadian mining journal, which is important in its field but has only a small circulation in the United States (R. 2221–2222; Pet. App. B, 35). The article was based on an interview with Texas Gulf officials three days earlier and described only a 10,000,000-ton ore reserve, as compared to the 25,000,000-ton ore reserve to be announced in Texas Gulf's own press release (R. 908, 915; Pet. App. B, 34–35, 41). The Texas Gulf official who was in charge of relations with *The Northern Miner* did not consider the article to constitute an announcement by Texas Gulf (R. 999). The record does not indicate that any seller of Texas Gulf stock in the United States was aware of this article prior to the time that petitioner placed his order to purchase Texas Gulf stock (R. 2548),[1] and petitioner does not claim that he had any knowledge of the *Northern Miner* article on April 16.

[1] *The Northern Miner* was generally available in Toronto prior to the opening of the market on April 16, and some stock-

The scheduled meeting of the board of directors started at 9:00 a.m. on April 16 with petitioner in attendance (R. 148). After the completion of other business, the president of the corporation either read the press release to the directors or allowed them to read it themselves (R. 199–200). He also indicated that on the previous evening the Ontario Minister of Mines had made a statement about the discovery on radio and television in Canada (R. 89).[2] Petitioner questioned the president of the corporation to make

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brokers there teletyped and telephoned excerpts from the article to their correspondent stockbrokers in New York City (*e.g.*, R. 2187–2190). There is no evidence, however, that a single Texas Gulf stockholder who sold his shares on the morning of April 16 had been informed about the *Northern Miner* article by his stockbroker before his order to sell was executed.

[2] The Ontario Minister had issued no statement on April 15 (R. 164), although Texas Gulf officials had been under the "impression" that he would read a statement they had prepared about the discovery over radio and television from Toronto, Canada, at 11 p.m. that night (R. 1068–1069). The statement prepared for the Minister, however, was "not the same announcement" as Texas Gulf's own press release that it also drafted on April 15 (R. 1110, 1210). It contained no details about the size of the ore body, the tonnage of the ore reserves, the values of the mineralization within the drill cores or Texas Gulf's land rights in the area of the discovery (Pet. App. B, 36, 40–41). Indeed, it did not even state that a "major strike" had been made (Pet. App. B, 36, 40–41). All of these details were included in Texas Gulf's own press release (Pet. App. B, 36, 40–41). The Minister's statement was sent to the press gallery of the Ontario Parliament at 9:40 a.m. on April 16 (R. 4812). There is no evidence in the record that there were

sure that Texas Gulf actually had a major discovery (R. 149).

The board meeting ended shortly before 10:00 a.m., and the representatives of the press were then brought into the directors' room (R. 150). The press release was distributed, the president read it aloud and answered questions and five or six slides of the drill-site were shown (R. 90, 2450–2451). The press conference lasted for 10 or 15 minutes (R. 92). "[E]arly on in the press conference" some reporters began to leave the room (R. 205). Some of the reporters apparently stayed through the end of the press conference and then went into an adjoining office to examine the drill cores (R. 151–152).

Petitioner was unaware which reporter represented any particular news medium and therefore did not know whether the reporter from the Dow Jones Instant News Service left early or stayed through the press conference and then went to examine the drill cores (R. 166–167). The Dow Jones reporter actually left the meeting after the president had read the press release and answered "one or two quick questions" (R. 2451). He called his office and spent about ten minutes dictating a story in two sections (R. 2453). The story appeared on the Dow Jones

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any representatives of the press there at that time, or that the statement was ever reported in the United States or Canada. The president of Texas Gulf, who was aware of the substantial differences between the Minister's statement and Texas Gulf's own release, described the former to the board of directors as being "to the effect that Texas Gulf had discovered north of Timmins what was considered to be a mineable zinc-copper ore body" (R. 1207–1211). He told them nothing more about the content of the statement (R. 1211).

broad tape between 10:54 and 11:02 a.m. in two sections (R. 2455; Pet. App. B, 41).[3]

The record does not indicate the exact time when petitioner left the board room. It was stipulated, however, that at 10:20 a.m. the first of his orders to purchase 2000 shares of Texas Gulf stock for the four family trusts was transmitted to the Midwest Stock Exchange by his son-in-law, a stockbroker in Houston (R. 152, 4794). Before that transmission took place, petitioner had called his law office in Houston, his office had placed another call to put him through to his son-in-law, he had discussed the matter with his son-in-law, his son-in-law had called his firm's floor broker in New York to check the market activity in Texas Gulf stock and only then had the son-in-law entered the orders with the firm's teletype operation in Houston (R. 160–163; J.A. 1680a–1682a).[4] The entire 2000 shares were purchased on the New York and Midwest Stock Exchanges by 10:51 a.m. at prices ranging from 31 to 31⅝ (R. 4794; Pet. App. B, 14). In addition, petitioner's son-in-law divulged the news about the discovery to four of his customers, and they and the son-in-law himself purchased an additional 1500 shares on the exchanges that day (April 16) at prices ranging from 31¼ to 35 (R. 4794; Pet. App.

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[3] The first section would normally have appeared on the broad tape within two or three minutes after the reporter had dictated it. Neither the parties nor Dow Jones has ever been able to discover an explanation for the delay.

[4] "J. A." refers to the Joint Appendix in the court of appeals, a copy of which, along with a copy of petitioner's brief and petition for rehearing in that court (cited on p. 18, *infra*), has been lodged in this Court.

B, 14).[5] The Texas Gulf stock reached a high that day of 37, and by May 15 it was selling at 58¼ (Pet. App. A, 3604).

3. THE DECISION OF THE DISTRICT COURT AS TO PETITIONER

The district court found that petitioner "lost no time in telephoning his son-in-law in order to purchase TGS stock for his family trusts" (Pet. App. B, 42). It also found that, if the officers of Texas Gulf had thought that the "effect [of the rumors, the article in *The Northern Miner* and the assumed statement by the Minister of Mines] was to make the information public there would have been little purpose in making the arrangements for a press conference, and issuing a detailed announcement on April 16" (Pet. App. B, 37). It concluded that the news "did not become public knowledge prior to TGS's official announcement" (Pet. App. B, 37). Finally, the district court found that petitioner "could not * * * assume 'without thinking about it, that the [ore discovery] was already a matter of public information'" when he made the telephone call to his son-in-law (Pet. App. B, 42).

The district court agreed with the Commission that Section 10(b) and Rule 10b–5 prohibit corporate insiders from purchasing their corporation's securities on a national securities exchange when the purchases are made on the basis of material information about the corporation that is unavailable to the sellers (Pet. App. B, 20–24). It also agreed that the Commission

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[5] The son-in-law and his four customers all sold out the next day at a profit (J.A. 1688a).

need not prove scienter or intent to deceive in an enforcement action such as this (Pet. App. B, 18–20). It held, however, that the announcement of the mineral discovery had been made the moment that the press release was given to the reporters, "and it has been the generally accepted rule that it is the making of the announcement that controls" as to when important corporate developments are considered sufficiently public to allow insiders to trade on the basis of the information (Pet. App. B, 42). In the district court's view, that standard could be changed only by a specific regulation of the Commission or by further legislation (Pet. App. B, 43–44). Solely on this basis, it held that petitioner had not violated Section 10(b) and Rule 10b–5 and dismissed the complaint against him, even though it held against another insider who had placed a purchase order on the basis of the same information less than two hours earlier (Pet. App. B, 39–40, 44, 58).[6]

4. THE DECISION OF THE COURT OF APPEALS AS TO PETITIONER

All nine judges of the court of appeals agreed with the district court that Section 10(b) and Rule 10b–5 prohibit corporate officials from trading on the basis of material inside information that has not been disclosed (Pet. App. A, 3605–3607) and that an insider's good faith does not excuse him from his duty of disclosure if he reasonably should have been aware of the

[6] The district court did not reach the question whether Section 10(b) and Rule 10b–5 prohibit the giving of such insider information for trading by others (Pet. App. B, 62 n.13).

duty (Pet. App. A, 3619–3622). Moreover, as to the rumors, the assumed "abbreviated report" by the Minister of Mines and the *Northern Miner* article, they further all agreed that "rumors and casual disclosure through Canadian media, especially in view of the April 12 gloomy or incomplete release denying the rumors and promising official confirmation, hardly sufficed to inform traders on American exchanges * * *" (Pet. App. A, 3622). In addition, they held that the giving of "tips" by insiders is illegal (Pet. App. A, 3615–3616 & n.16).[7]

Contrary to the holding of the district court, the court of appeals unanimously ruled that the reading of the press release to the reporters was "merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments" (Pet. App. A, 3618). The appellate court also held that "effective protection of the public from insider exploitation of advance notice of material information requires that the time that an insider places an order, rather than the time of its ultimate execution, be determinative for Rule 10b–5 purposes" (Pet. App. A, 3616 n.17). Since the court agreed with the district court that petitioner "could not reasonably have expected the official release to have been disseminated when he placed his order before 10:20 for immediate execution * * *," it concluded that "at the minimum Coates should have

[7] The two dissenting judges did not expressly discuss these questions but necessarily concurred in the majority holdings by joining in the reversal as to petitioner (Pet App. A, 3691).

waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law" (Pet. App. A, 3618–3619, 3622).[8] The two judges who dissented as to others of the defendants agreed as to petitioner "because for all practical purposes the information had not become public at the time of his purchase order" (Pet. App. A, 3691).

5. THE OTHER DEFENDANTS

The district court held that two other individual defendants had violated Section 10(b) and Rule 10b–5, and that Texas Gulf and nine other individual defendants had not (Pet. App. B, 58). The court of appeals affirmed as to the two individuals who had been found to be violators and as to one who had not, and reversed as to all the other defendants (Pet. App. A, 3639). It remanded the case for further proceedings as to whether Texas Gulf had violated the law and the remedies to be imposed on the violators (Pet. App. A, 3638–3639). These proceedings have not yet taken place.

Although the time for filing petitions for certiorari to review the decision below has run, only one of the

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[8] The court also noted that in some situations the mere appearance of news on the broad tape should not be sufficient to allow insiders to trade and suggested rule-making by the Commission to deal with the problem (Pet. App. A, 3618 n.18). It did not fully discuss this matter, however, because the only defendant whose conduct raised the problem was no longer a party to the appeal (Pet. App. A, 3618 n.18).

other individual defendants has filed a petition (No. 937, this Term). That petition raises basically different questions from this one. Texas Gulf has announced that it intends to petition for certiorari "in due course" (presumably after further proceedings on the remand to the district court and a subsequent decision by the court of appeals). CCH Fed. Sec. L. Rep. ¶ 77,589 (Aug. 15, 1968).

ARGUMENT

All the judges of both courts below, and every other court that has considered the matter, have correctly determined that Section 10(b) and Rule 10b–5 prohibit a corporate insider from trading in the corporation's securities in the market on the basis of important information not available t the public. Indeed, petitioner seems to contest this basic proposition only obliquely. The real issue raised by the petition is only the narrow one whether insiders may trade after announcement of dramatic corporate news but before its publication in any news medium of widespread circulation. The negative answer to this question given by a unanimous *en banc* court below—as to where there is no conflict with any other circuit—does not warrant further review.

1. The protection afforded investors by the prohibition against trading on the basis of material inside information would be seriously undercut if that prohibition were to be lifted at the very moment that dramatic news is handed out to the news media, but before it actually becomes available to the stockholders of the corporation and the investing public in any

meaningful sense.[9] As the court of appeals correctly reasoned, in this type of situation "[b]efore insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public" (Pet. App. A, 3617–3618).

The fact that such dramatic news should be published before insiders may trade was recognized long before the enactment of the federal securities laws. For example, Judge Elbert H. Gary, who, as chairman of the board of the United States Steel Company was a leading spokesman for the business community, refused to buy his corporation's stock on the basis of a dividend increase until the day afterwards, so that he would buy "on even terms with the whole world." [10]

Today, with the general use of telecommunications, the Dow Jones broad tape is usually the first widespread publication of important corporate news. Prior to the events of this case it had been considered one

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[9] Petitioner does not contest the holding of both courts below that the "unreliable" rumors, the unmade "abbreviated report" by the Minister of Mines and the article in the *Northern Miner* were legally insufficient for this purpose (see pp. 6–8, 10, 12 *supra*).

[10] A. Cotter, *The Gary I Knew*, 64–67 (1928).

Nor did he have a different attitude with respect to "tips," as appears from the following anecdote:

> If Judge Gary had a son who was in the brokerage business and the Judge knew at three o'clock in the afternoon that an extra dividend would be declared the son would not know it until the newspaper had it the next day.

I. Tarbell, *The Life of Elbert H. Gary, the Story of Steel* 342 (1925).

of the "sanitary precautions" to keep corporate directors away from the telephone until after dramatic corporate news has appeared on the broad tape.[11] Indeed, petitioner testified that declarations of dividends were usually announced by Texas Gulf while directors' meetings were still in progress, and that they would appear on the broad tape before the meeting "had a chance to adjourn" (R. 170).

Petitioner seems to suggest that fairness requires that insiders be permitted to trade at the same time that certain members of the public may do so (Pet. 16–17). His own situation belies this suggestion, as he had generally been aware of the news since the preceding afternoon and received the details half an hour or so before those present at the press conference (see pp. 6–8, 10, *supra*). He thus had an advance opportunity to consider and evaluate it and had a head-start even over those at the press conference. Moreover, in the well known words of then Chief Judge Cardozo, "many forms of conduct permissible in a work-a-day world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place." *Meinhard* v. *Salmon,* 249 N.Y. 458, 464, 164 N.E. 545, 546.[12]

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[11] See Remarks of Mr. Thomas A. Halleran of the New York Bar in Symposium, "Insider Trading in Stocks," 21 Bus. Law. 1009, 1022 (1966).

[12] Contrary to the implications in the petition (Pet. 17), the Commission never argued that the reporters could have called their stockbrokers before their newspapers, or that certain selected brokers were properly present at the press conference.

Petitioner, as a director, of course stood in a fiduciary relationship to the corporation's stockholders.

In view of the unique situation here involved, the holding below that petitioner is liable on the basis of the purchase order he made by telephone does not, contrary to his suggestion (Pet. 17), raise either the question whether some further dissemination than appearance on the Dow Jones broad tape is necessary, or whether a waiting period after dissemination is necessary in order to give the public an opportunity to evaluate the news. The limited scope of the issue means that a decision by this Court would be of limited significance to the other insiders of Texas Gulf or to insiders of other corporations with securities listed on the New York Stock Exchange. Entirely apart from the Act, the Stock Exchange requires insiders of its listed corporations to wait until after the news of "important developments has appeared in the press before making a purchase or sale." New York Stock Exchange, *Company Manual* A–26 (July 18, 1968).

2. Petitioner also claims that he reasonably believed that the news was already available to the public when he telephoned, and that, in any event, the Commission is required to prove that he actually knew that it was unavailable (Pet. 18–21). Both the district court and court of appeals found, however, that he could not have reasonably believed that the news " 'was already a matter of public information' " (see pp. 10, 12–13, *supra*)—a finding that is amply

supported by the evidence (see pp. 6-9, *supra*).[13] Petitioner's legal argument is a reversal of his position in the court of appeals that the Commission's burden would be satisfied if it proved that he "knew *or had reason to know* that his silence would be misleading" (Brief for Appellee Coates, pp. 24, 26, 29) (emphasis added).[14] As held in *Securities and Exchange Commission* v. *Capital Gains Bureau*, 375 U.S. 180, 200, an enforcement proceeding under the analogous anti-fraud provision of another of the federal securities laws,

> to impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute.[15]

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[13] The court of appeals did not misunderstand the testimony about Dow Jones' procedures, as petitioner argues (Pet. 20–21 & n.). Although the news could have begun to appear on the broad tape between 10:13 and 10:18 a.m. (Pet. 21), an insider should no more be free to trade after the first sentence of the release appeared than he would if the whole release had been given to him and only the first sentence to the reporters. The complete broad tape report could not have appeared before 10:22 a.m. (see pp. 8–9, *supra*). In any event, although neither court below determined exactly how long before 10:20 a.m. petitioner telephoned his son-in-law, the evidence indicates that it was prior to 10:18 (see pp. 9, 12, *supra*).

[14] In his petition for rehearing before that court (pp. 7–9), however, he urged that, if Rule 10b–5 is so construed, it is unconstitutional.

[15] The Court's earlier comment in a footnote that the failure to disclose in that case was "purposeful," 375 U.S. at 192 n.39, hardly detracts from its broad holding.

The same principle necessarily applies in Commission enforcement actions under Section 10(b) and Rule 10b–5 and has been held to apply under the cognate antifraud provision of the first securities act.[16] Indeed, many federal courts go even further.[17] Petitioner cites no federal decision to the contrary.[18] As the Court of Appeals for the Seventh Circuit held in *Kohler* v. *Kohler Co, supra,* 319 F. 2d 634, 642 (emphasis added), insiders must "scrupulously disclose to outsiders those material facts about a corporation * * * which the insiders *should reasonably believe* are unknown to the outsider."

3. Petitioner also seems to argue, although not explicitly, that Section 10(b) and Rule 10b–5 permit a corporate insider, without appropriate disclosure, to purchase securities in his corporation in an orga-

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[16] *Securities and Exchange Commission* v. *Van Horn*, 371 F. 2d 181 (C.A. 7); Note, 63 Mich. L. Rev. 1070, 1076 (1965).

[17] *E.g.*, *Myzel* v. *Fields*, 386 F. 2d 718, 734–735 (C.A. 8), certiorari denied, 390 U.S. 951; *Stevens* v. *Vowell*, 343 F. 2d 374, 379–380 (C.A. 10); *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210, 212 (C.A. 9), judgment for plaintiffs affirmed, 333 F. 2d 568 (C.A. 9); *United States* v. *Schaefer*, 299 F. 2d 625, 629 (C.A. 7), certiorari denied, 370 U.S. 917; *Ellis* v. *Carter*, 291 F. 2d 270, 274 (C.A. 9), dismissal affirmed, 328 F. 2d 573 (C.A. 9); *Texas Continental Life Ins. Co.* v. *Bankers Bond Co.*, 187 F. Supp. 14, 22–23 (W.D. Ky.), reversed on other grounds sub nom. *Texas Continental Life Ins. Co.* v. *Dunne*, 307 F. 2d 242 (C.A. 6).

[18] There is no inconsistency between the decision below as to petitioner and the court's quotation from the Commission's decision in *Cady, Roberts & Co.*, 40 S.E.C. 907, 912, as petitioner argues (Pet. 18). That case involved a broker who clearly knew that the news was unavailable, and the Commission limited its language accordingly. But that is no reason to conclude that proof of actual knowledge is necessary.

nized securities market on the basis of information that he knows to be material and not available to the public (Pet. 11–16).[19] He bases this conclusion on the premise that an insider has no duty to disclose material inside information when trading on an exchange (Pet. 14–16), and that such conduct is therefore not fraudulent or deceptive. But such a duty clearly exists.

The Congress that passed the Act firmly held the view that corporate officials owe fiduciary duties directly to the stockholders and not merely to the fictional corporate entity. S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), pp. 55, 67–68.[20] "Among the most vicious practices unearthed * * * [in the legislative hearings] was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid

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[19] Petitioner was held to have violated Section 10(b) and Rule 10b–5 not only by his own purchases but also by his having given a tip to his son-in-law (see pp. 9–10, 12, *supra*). He does not contend that such a tip would be lawful if given with knowledge that the information was not available to the public. See *Ferraioli* v. *Cantor*, 281 F. Supp. 354 (S.D. N.Y.); *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, CCH Fed. Sec. L. Rep. ¶ 77,629 (S.E.C.); cf. *Kuehnert* v. *Texstar Corp.*, 286 F. Supp. 340 (S.D. Tex.); *Ross* v. *Licht*, 263 F. Supp. 395 (S.D. N.Y.); *Blyth & Co.*, CCH Fed. Sec. L. Rep. ¶ 77,647 (S.E.C.); *Herbert L. Honohan*, 13 S.E.C. 754, 757–758, modified in other respects, 16 S.E.C. 297; 3 L. Loss, *Securities Regulation* 1450–1451 (2d ed. 1961). See also, *Mosser* v. *Darrow*, 341 U.S. 267, 271–272.

[20] Accord, H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), pp. 5–6, 11, 13; 78 Cong. Rec. 7861–7862, 8037, 8038 (1934).

them in their market activities." *Id.* at 55.[21] Indeed, some 60 years ago, long before the passage of the Act, this Court held that, when he is making such purchases, a corporate insider is under a duty to disclose when "special facts" exist. *Strong* v. *Repide,* 213 U.S. 419, 431. Since the passage of the Act, the federal courts have uniformly held that Section 10(b) and Rule 10b–5 require insiders to disclose material inside information to those from whom they purchase their corporation's securities.[22]

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[21] This language is contained in the section of the report dealing with "Market Activities of Directors, Officers, and Principal Stockholders of Corporations." Section 16(b) of the Act, 15 U.S.C. 78p(b), provides for the recovery by the corporation of profits from short-swing transactions by such persons. Although petitioner does not claim that Section 16(b) of the Act preempts the insider trading field, he does purport to find some support in it (Pet. 13–14). The district court in this case spelled out at length the differences between Section 10(b) and Section 16(b) and the reasons why the provisions of the latter impose no limitation on the former (Pet. App. B, 20–21). Moreover, as this Court has already held under another of the securities laws, a provision comparable to Section 16(b) does not impose additional restrictions on other provisions of the statute, since it "cannot be regarded as a limitation upon the power of the Commission to deal with other situations in which officers and directors have failed to measure up to the standards of conduct imposed upon them * * *." *Securities and Exchange Commission* v. *Chenery Corp.*, 318 U.S. 80, 91. Cf. *Securities and Exchange Commission* v. *National Securities, Inc.*, No. 41, this Term, decided January 27, 1969, slip op., p. 15.

[22] *Myzel* v. *Fields, supra; List* v. *Fashion Park Inc.*, 340 F. 2d 457 (C.A. 2), certiorari denied, 382 U.S. 811; *Kohler* v. *Kohler Co., supra; Reed* v. *Riddle Airlines*, 266 F. 2d 314 (C.A. 5); *Cochran* v. *Channing Corp.*, 211 F. Supp. 239, 242–243 (S.D. N.Y.); *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del.), final judgment awarded, 135 F. Supp. 176 (D. Del.), affirmed as modified, 235 F. 2d 369 (C.A. 3); *Kardon* v. *National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa.), modified in other respects,

As the courts below recognized, this duty to disclose, whether it be stated in terms of special facts or undisclosed material facts, should not be limited to face-to-face transactions. Such a limitation, as the court below had previously pointed out, "would be contrary to the intent of Congress, as set forth in section 2 of the Securities Exchange Act, 15 U.S.C. § 78b, which was to regulate 'transactions in securities as commonly conducted upon securities exchanges [as well as] over-the-counter markets.'" *List* v. *Fashion Park, Inc., supra,* 340 F. 2d at 462.[23]

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83 F. Supp. 613 (E.D. Pa.); *Mansfield Hardwood Lumber Co.* v. *Johnson*, 268 F. 2d 317, 319 n.3 (C.A. 5) (dictum), certiorari denied, 361 U.S. 885.

Petitioner claims that the cases under the Act turn, like *Strong*, on the existence of "special facts," and that the materiality of the undisclosed information cannot itself be regarded as a special fact giving rise to a duty to disclose it (Pet. 15–16). But the commentators uniformly consider the special facts in *Strong* to have been the importance of the corporate development and the insider's role in it, and the courts have frequently found liability under the special facts doctrine on this basis. R. Baker & W. Cary, *Cases and Materials on Corporations* 559–560 (3d ed. unabr. 1959); 3 W. Fletcher, *Private Corporations* § 1171 (perm. ed. rev. rep. 1965); 3 L. Loss, *supra*, at 1447–1448; R. Stevens, *Corporations* 582–583 (1936).

[23] The *List* opinion also answered petitioner's contention that purchases of stock on a national securities exchange on the basis of material inside information do not induce other investors to sell their stock at that time (Pet. 11–13, 16), pointing out that the concept of reliance is not limited to a situation in which the investor

> actively relied on the silence of the defendant, either because he consciously had in mind the negative of the fact concealed, or perhaps because he deliberately put his trust in the advice of the defendant. * * * The proper test is whether the plaintiff would have been influenced to act

Indeed, disclosure is more important in impersonal transactions because the stockholder who deals with an insider on a face-to-face basis has an opportunity to make informal inquiry whether the insider is in possession of any material information not available to the public.[24] "Dishonest directors should not find absolution from retributive justice by concealing their identity from their victims under the mask of the stock exchange." H. Ballantine, *Corporations* 216 (rev. ed. 1946).

4. Relying on the Fifth Amendment, petitioner also complains that Rule 10b–5 is not sufficiently definite to have given him notice that his conduct was proscribed (Pet. 21–25).

In this area "[t]he test is whether the language conveys sufficiently definite warning as to the proscribed conduct when measured by common understanding and practices." *Jordan* v. *DeGeorge,* 341 U.S. 223, 231–232; accord, *Sproles* v. *Binford,* 286 U.S. 374, 393; *McGowan* v. *Maryland,* 366 U.S. 420, 428; *United States* v. *National Dairy Prods.,* 372 U.S. 29, 32. See, also, *Securities and Exchange Commission* v. *Capital Gains Bureau, supra.*

There are, of course, some areas of the law in which it is not possible to anticipate all kinds of harmful

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differently than he did act if the defendant had disclosed to him the undisclosed fact.

340 F. 2d at 463. *Accord, Myzel* v. *Fields, supra,* 386 F. 2d at 735. If insiders are under a duty to disclose material inside information when relying on that information in purchasing securities on a stock exchange, their conduct necessarily deceives other investors in the market if they do not fulfill that duty.

[24] Cf. *Broffe* v. *Horton,* 172 F. 2d 489, 494 (C.A. 2).

conduct by specific rules. Prohibitions of fraud and deception fall within this category. Rule 10b–5 is, therefore, necessarily stated in rather broad terms which absorb their meaning from the particular business context in which the deceptive practices occur. Cf. *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 202–203.[25]

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[25] The court of appeals has suggested that the Commission use its rulemaking power to achieve clarification of the timing problem—at least with respect to a waiting period after publication (see n. 8, *supra*). Such a waiting period is no longer an issue in this case. Nevertheless, although the Commission's initial judgment was that a specific rule on this subject would be undesirable, it will re-evaluate that position in light of the views of the court below. But the fact that the Commission may yet be able to devise such a rule based upon its experience with this case does not mean that it was required to have anticipated petitioner's situation by a more specific rule. *See* remarks of Judge Friendly in "Conference on Codification of the Federal Securities Laws," 22 Bus. Law 793, 900, 901 (1967).

CONCLUSION

Despite the significance of the case out of which this petition for a writ of certiorari arises, the petition itself does not present any questions warranting review by the Court and should be denied.

Respectfully submitted.

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FEBRUARY 1969.

U.S. GOVERNMENT PRINTING OFFICE: 1969

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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 937

HAROLD B. KLINE, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 66a–171a) is reported at 401 F. 2d 833. The opinion of the district court (Pet. App. 1a–63a) is reported at 258 F. Supp. 262.

JURISDICTION

The judgment of the court of appeals was entered on August 13, 1968, and the court denied petitioner's timely petition for rehearing on October 15, 1968. The petition for a writ of certiorari was filed on January 13, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder prohibit a member of a corporation's top management from accepting an incentive stock option, purportedly based upon the fair market value of the underlying shares, without disclosing to the directors who grant the option corporate information that might be expected substantially to affect the value of the corporation's stock and that would be of importance to a reasonable, although speculative, investor.

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b–5 of the Commission, 17 CFR 240.10b–5, are set out in the petition (Pet. App. 174a–176a).

STATEMENT

This action arises out of "a major strike of zinc, copper and silver * * *" (Pet. App. 40a) by Texas Gulf Sulphur Company ("Texas Gulf") on land located near Timmins, Ontario, Canada. The exploratory drilling that preceded a release distributed at a press conference announcing this discovery on April 16, 1964, was carried out by Texas Gulf during a period of some five months (Pet. App. 1a). The court below found that, prior to sufficient dissemination of this announcement to the public, ten officers, directors and employees of Texas Gulf who possessed various degrees of information about the results of the drilling at various stages in the exploration all

engaged in securities transactions in violation of Section 10(b) and the Commission's Rule 10b–5. Petitioner is one of the ten.[1]

1. THE COMMISSION'S COMPLAINT

On April 19, 1965, the Commission filed a complaint (R. 2851–2885) in the district court alleging that, during the course of the exploratory drilling and before the information contained in the April 16 press release became available to the public, thirteen officers, directors and employees of Texas Gulf, including petitioner, had each committed one or more of the following violations of Section 10(b) and Rule 10b–5:

> 1. Purchased Texas Gulf common stock or calls on that stock on the basis of the results of the drilling without appropriate disclosure.
>
> 2. Divulged that information to friends, relatives or business associates for use in their purchases of Texas Gulf stock or calls, without appropriate disclosure, or recommended on the basis of such inside information that they purchase Texas Gulf securities.
>
> 3. Accepted stock options from Texas Gulf while this information was concealed from its directors.

It also alleged that Texas Gulf had violated Section 10(b) and Rule 10b–5 by the issuance of a false and misleading press release about the ore deposit on April 12, 1964.

The complaint requested that the defendants be

[1] Another of the ten is the petitioner in *Coates* v. *Securities and Exchange Commission*, No. 897, this Term, in which the Commission has filed a brief in opposition.

permanently enjoined from future similar violations of Section 10(b) and Rule 10b–5; that the individual defendants who had violated those provisions by purchasing Texas Gulf stock or calls be required to offer rescission to the sellers; that those who had divulged such information be required to offer restitution to stockholders who had sold Texas Gulf securities to the recipients of the information; and that stock options accepted by the defendants be rescinded (R. 2883–2885).

2. THE EVIDENCE RELEVANT TO PETITIONER

In 1963, Texas Gulf was a narrowly-based company deriving 97 per cent of its income from sulphur (R. 1842). Because of an over-supply of sulphur on the world market, during the period from 1955 to 1963 its annual sales and earnings and the market price of its common stock had declined (Pet. App. 2a–3a).

Although the sulphur market had begun to improve by late 1963, Texas Gulf was endeavoring to deal with its depressed business situation by diversifying into related fields (Pet. App. 3a–4a). One aspect of this diversification was an exploratory program for base metal sulphides[2] in Canada (R. 661; Pet. App. 5a), which, if successful, would open a new area of corporate opportunity for the company (R. 1552–1553). Up to November 1963, however, the corporation had spent six years and millions of dollars in exploring more than 15,000 square miles of eastern Canada without success (Pet. App. 5a, 8a; J.A. 1723a).[3]

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[2] Sulphides are chemical combinations of sulphur with other elements (Pet. App. 59a n.2).

[3] "J.A." refers to the joint appendix in the court of appeals, a copy of which has been lodged in this Court in connection

On one square-mile plot of land located near Timmins an aerial geophysical survey, confirmed by subsequent geophysical investigations on the ground, indicated the existence of a wide "first class" anomaly* some 1000 feet in length (Pet. App. 6a, 8a, 29a). Texas Gulf had an option to purchase the northeast quarter section of that segment (Pet. App. 6a).

In November 1963, Texas Gulf drilled one exploratory drill hole on this section (Pet. App. 8a). Although the anomaly could have been caused by worthless materials (Pet. App. 59a n.3), a visual examination of the core recovered from the hole revealed such high copper and zinc values over a length so great—approximately 600 consecutive feet of the core's 657 foot length (Pet. App. 27a–28a)—that four expert witnesses called by petitioner had never seen or heard of a comparable initial exploratory drill hole in a base metal mineral deposit (R. 723–727, 800, 1471–1476, 1584–1586, 1610–1613, 1715–1717, 1944–1946, 1967–1968). Moreover, the mineralization began 26 feet below the surface of the earth (P.X. 11, p. 1). This drill hole has been described as "one of the most impressive drill holes completed in modern times"

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with the petition for certiorari of one of the other individual defendants (*Coates* v. *Securities and Exchange Commission*, No. 897, this Term). "P.X. ——" refers to certain of the Commission's exhibits, copies of which have been lodged in this Court in connection with the present petition.

*An anomaly is a deviation from the normal in the earth's crust of such physical characteristics as electrical conductivity (R. 665).

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(Pet. App. 90a n. 13) and "just beyond your wildest imagination" (J.A. 1719a).

The "excited" company geologist who had been at the drillsite called from Timmins to his superior's home in Stamford, Connecticut, on a Sunday evening to report the initial intersection of copper mineralization (R. 898, 4818–4819). Within two days this and subsequent reports had brought three top executives of Texas Gulf, including the second senior officer of the corporation, to Timmins from New York under conditions of great personal discomfort (R. 889, 898, 956–960, 1122–1127). As a result of the information thus obtained by the top management of Texas Gulf, security measures were taken to keep the results of the drilling secret so that the corporation could acquire the remainder of the land at favorable prices (R. 1240–1241, 4801–4802). These included an order by the president of the corporation that no one outside the exploration group, not even the nonmanagement directors, should be told about the drilling results (R. 1205–1206). Drilling was suspended and was not resumed until after the transaction involved in this petition (R. 4802–4805).

At the time when the first hole was drilled, petitioner was vice president-administration and secretary of Texas Gulf (R. 4791). Sometime "near the midpoint of November, 1963" the president and executive vice president of the corporation discussed the drilling results with petitioner (Pet. App. 196a). Petitioner testified that he was told that the drill hole "had intercepted a sulphide body" containing copper and zinc, and that it was considered "a favorable de-

velopment" (Pet. App. 196a). He was also told that the drilling was done on the boundary of Texas Gulf's property, and that the corporation wished to acquire the adjoining land (Pet. App. 197a).[5]

On January 24, 1964, petitioner became general counsel of Texas Gulf in addition to his other duties (Pet. App. 191a, 197a). In these capacities he attended a meeting of the incentive stock option committee of Texas Gulf's board of directors on February 20, 1964 (Pet. App. 191a–192a). At that meeting the committee recommended the granting of options on 89,950 shares of Texas Gulf stock to officers and employees of Texas Gulf (P.X. 5, p. 2), including an option on 4300 shares to petitioner (Pet. App. 177a; P.X. 5, p. 2). Pursuant to the secrecy order of the corporation's president (see p. 6, *supra*), who had recommended the granting of the options, the news of Texas Gulf's discovery of copper and zinc in Timmins had been withheld from the members of the com-

[5] Although a telephone call from Canada was mentioned in the discussion (Pet. App. 196a), the evidence does not indicate whether this was the first telephone call from Canada, or, if so, that petitioner's discussion about the drilling results took place between that call and the completion of the first hole.

Petitioner testified that in the discussion he inquired whether the sulphide mineralization discovered at Timmins was "similar in terms of composition" to mineralization found in two other areas by Texas Gulf (Pet. App. 196a). Although the other two deposits were not sufficiently rich to be mined (R. 743), there is no evidence that any comparison was made to them in terms of richness, as distinguished from the chemical composition of the mineralization. The first hole in Timmins was far more impressive than the first holes in the other two locations (R. 725–727; see pp. 5–6, *supra*).

mittee (Pet. App. 179a, 181a–182a, 186a–188a). Although the committee expressly stated that the options were intended to be granted at the "fair market value" of the underlying stock and assumed the stock exchange prices to represent that value, petitioner, who was present while they discussed this matter, did not reveal to them anything about the drilling results (Pet. App. 181a, 197a–198a; P.X. 5, p. 3). After the meeting of the committee, petitioner also attended a meeting of the full board, at which the recommended options were granted (Pet. App. 177a, 192a).[6] None of the nonmanagement directors knew about the drilling results (Pet. 8). Petitioner thereafter handled the mechanics of issuing the options (Pet. App. 192a–195a).

Although the options thus granted have been surrendered to the corporation by two other officers of Texas Gulf, petitioner still retains his (Pet. 9; R. 4814). On July 15, 1965, after the institution of this lawsuit, Texas Gulf's board of directors resolved that the option granted to petitioner had "been beneficial" to the corporation and was expected to continue to be so (Pet. App. 178a).

3. THE DECISION OF THE DISTRICT COURT AS TO PETITIONER

The district court held that "[a] corporate officer may be guilty of fraud if he withholds material information from his company to his own advantage" (Pet. App. 48a). It also recognized that in granting

[6] He was succeeded as secretary of the corporation at the meeting (Pet. App. 192a).

incentive stock options the directors of the company necessarily rely on information furnished to them by the top management of the corporation (Pet. App. 47a), and that the latter are therefore "under a duty to inform * * * [them] of material information affecting the issuance of the stock options," including "material information bearing on the market value of * * * [the] stock on that date" (Pet. App. 48a). Thus, it agreed with the Commission that any member of top management who accepted a stock option from the corporation while withholding such information about its affairs from the directors would violate Section 10(b) and Rule 10b–5 (Pet. App. 48a–49a).

The district court held, however, that petitioner did not violate these provisions because the drilling results had not been material up to the date on which the options were granted (Pet. App. 49a). In reaching this conclusion, it held that, although "[t]here is no doubt that the [first] drill core * * * was unusually good and that it excited the interest and speculation of those who knew about it" (Pet. App. 29a), "* * * the test of materiality must necessarily be a conservative one * * *" (Pet. App. 26a). In its view, only long-term, conservative investors were to be protected against misuse of inside information (Pet. App. 25a–26a). In addition, it found that petitioner was not a member of Texas Gulf's top management, and that he "knew no details" about the drilling results (Pet. App. 47a–48a).

4. THE DECISION OF THE COURT OF APPEALS AS TO PETITIONER

The court of appeals decided the case *en banc*. The majority of seven judges agreed with the district court that under Section 10(b) and Rule 10b–5 "'* * * a member of top management * * * is required, before accepting a stock option, to disclose material inside information * * *'" to its directors (Pet. App. 103a n. 24). In determining whether the facts involved here were material, the court applied two alternative phrasings of the standard of materiality previously used in Rule 10b–5 cases: "'* * * whether a *reasonable* man would attach importance * * * [to the information] in determining his choice of action in the transaction in question,'" and whether "'* * * in reasonable and objective contemplation [the information] *might* affect the value of the corporation's stock or securities * * * '" (Pet. App. 87a) (emphasis in original).

It rejected the district court's "conservative" (Pet. App. 87a) standard. It held that all investors, including those with speculative objectives, are entitled to the protection of the Act (Pet. App. 88a). It ruled that the information about the first drill core was material, since it "might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold" (Pet. App. 89a).

With specific reference to petitioner, the court of appeals decided that he was a member of top management (Pet. App. 103a). It held that, although he "had

no detailed knowledge of the drilling progress * * *" (Pet. App. 102a), he violated his "duty before accepting his option to disclose any material information he may have possessed * * *" (Pet. App. 103a); and that this violation was not cured by the subsequent resolution by the board of directors, which the court termed a "ratification." The court ordered the rescission of petitioner's option (Pet. App. 103a and n. 24).

The two dissenting judges did not disagree that the "objective of protecting a corporation from selling securities to insiders at a price below their true worth * * *" was a proper one (Pet. App. 146a–147a). It was their view, however, that the appropriate time for disclosure with respect to stock options, at least during a period of corporate secrecy, is prior to exercise of the options rather than the time of their acceptance (Pet. App. 146a–147a).[7] In addition, they agreed with the district court that the results of the drilling were not material (Pet. App. 132a–145a).

5. THE OTHER DEFENDANTS

The district court held that two other individual defendants had violated Section 10(b) and Rule 10b–5, and that Texas Gulf and nine other individual defendants had not (Pet. App. 58a). The court of appeals affirmed as to the two individuals who had been found to be violators and as to one who had not and reversed as to all the other defendants before them

[7] The majority stated: "* * * as this suggestion was not presented to us, we do not consider it or make any determination with reference to it" (Pet. App. 103a n. 24).

(Pet. App. 118a). It remanded the case for further proceedings to determine whether Texas Gulf had violated the law and the remedies to be imposed on the violators (Pet. App. 118a). These proceedings have not yet taken place.

Although the time for filing petitions for certiorari to review the decision below has run, only one of the other individual defendants has filed a petition (*Coates* v. *Securities and Exchange Commission,* No. 897, this Term). That petition raises basically different questions from this one. Texas Gulf has announced that it intends to petition for certiorari "in due course" (presumably after further proceedings on the remand to the district court and a subsequent decision by the court of appeals). CCH Fed. Sec. Law Rep. ¶ 77,589 (Aug. 15, 1968).

ARGUMENT

All the judges of both courts below agreed that Section 10(b) and Rule 10b–5 require members of top management to disclose previously withheld material information to the directors of the corporation at some time prior to the exercise of incentive stock options granted to them. Both courts held that the appropriate time for such disclosure was prior to the acceptance of the options, although the two dissenting judges were of the view that the appropriate time during a period of corporate secrecy was prior to the exercise of the options, and the majority of the court of appeals indicated that this question was open for future cases (see n. 7, *supra*). In these circumstances,

there is no reason for review by this Court of the narrow question of timing.

The other issue raised is whether the facts which petitioner knew when his option was granted were material. The standard of materiality applied by the court of appeals in answering this question affirmatively was consistent with the standards used by other courts of appeals in cases under Section 10(b) and Rule 10b–5 and was correct. The application of that standard to the particular facts of this case was also proper and does not present an issue of sufficient general importance to warrant further review.

1. The court of appeals applied the two alternative phrasings of the standard of materiality commonly used in Rule 10b–5 cases: that the information is important to a "reasonable" investor and "in reasonable and objective contemplation" might affect the market price of the stock (see p. 10, *supra*).[8] The first phrasing of the standard is the same as the traditional common law tort standard,[9] and both have been adopted by other courts of appeals.[10] Petitioner cites

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[8] Petitioner argues that the court of appeals correctly stated that a *substantial* prospective market impact is necessary to render inside information material and then departed from this standard by dispensing with the requirement of substantiality (Pet. 17–18). We, however, read the phrase "in reasonable and objective contemplation" as designed to exclude matters which might cause insubstantial market fluctuations.

[9] See, *e.g.*, 1 Harper and James, *Torts* 565–566 (1956); Prosser, *Torts* 554–555 (2d ed. 1955); Restatement, *Torts* § 538(2)(a) (1938).

[10] *Myzel* v. *Fields*, 386 F. 2d 718, 734 and n. 7 (C.A. 8) certiorari denied, 390 U.S. 951; *Rogen* v. *Ilikon Corp.*, 361 F. 2d 260, 266 (C.A. 1); *Kohler* v. *Kohler Co.*, 319 F. 2d 634, 642 (C.A. 7); accord, *Securities and Exchange Commission* v. *R.A.*

two other decisions by courts of appeals that are claimed to be inconsistent with that of the court below (Pet. 16–17). One of them, *James Blackstone Memorial Library Ass'n* v. *Gulf, M. & O.R. Co.*, 264 F. 2d 445, 450–451 (C.A. 7), certiorari denied, 361 U.S. 815, is an earlier decision of one of the courts which has since adopted the second phrasing (see n. 10, *supra*). Moreover, the undisclosed information involved in that case could not possibly have affected the fair market value of the plaintiff's stock.[11] The other, *Sunray DX Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F. 2d 447 (C.A. 10), does not articulate any standard of materiality, and there is no indication that the drilling results in that case were as "remarkable" (R. 1717; see pp. 5–6 *supra*) as those here.[12]

Holman & Co., 366 F. 2d 456, 458 (C.A. 2), rehearing denied *per curiam*, 377 F. 2d 665 (C.A. 2), certiorari denied, 389 U.S. 991; *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (C.A. 2), certiorari denied, 382 U.S. 811. The court of appeals has used the first phrasing subsequent to the decision below, with one of the two dissenting judges here joining in the opinion. *Securities and Exchange Commission* v. *Great American Industries, Inc.*, CCH Fed. Sec. Law Rep. ¶ 92,325, at 97,540 (*en banc*).

[11] The undisclosed information concerned the possibility that certain property in the corporation's name might be sold to the government at an advantageous price. All the property of the corporation had already been leased to another party in perpetuity, however, and a sale at a large profit would not have affected the guaranteed dividend, which is all that plaintiffs were entitled to receive. 264 F. 2d at 447–448, 450.

[12] Neither of the two well holes in question was on the land involved there; one was over a mile away from its boundary. See unreported findings of fact and conclusions of law in the district court, p. 7, No. 68 C 92 (N.D. Okla).

Petitioner argues that the refusal of the court of appeals to limit the "reasonable" investors encompassed within the first phrasing of the materiality standard to long-term, conservative investors is inconsistent with certain rules of the Commission defining materiality in the context of registration statements and other similar filings (Pet. 15–16). There is no inconsistency. Certain of the filings with the Commission relate to securities which would be of interest only to speculators, while others describe securities appealing to more conservative investors. The Commission's standard of materiality for registration statements applies to both.[13] Moreover, as this Court has recently stated,

> Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase "unless the context otherwise requires."

Securities and Exchange Commission v. *National Securities Inc.*, No. 41, this Term, decided January 27, 1969, slip op., p. 12. The rules cited by petitioner supplement specific detailed requirements for the disclosure of specific information. They have been drafted in light of the Commission's experience, in obtaining

[13] The Commission has a special registration form for securities of a speculative nature, which must be so labeled. Form S–2, General Instruction D(b), reprinted in 1 CCH Fed. Sec. Law Rep. ¶ 7142, at 6241–6242; see, also, Form S–3, General Instruction E(b), reprinted in 1 CCH Fed. Sec. Law Rep. ¶ 7152, at 6262. Registrants are not allowed to leave these forms blank merely because the information required would be important only to speculators.

information in that context, whether of interest merely to long-term, conservative investors or to all reasonable buyers and sellers of securities. Congress, in designing the Act "* * * to prevent inequitable and unfair practices on * * * exchanges and markets * * *," 48 Stat. 881, did not intend to exclude speculative investors from its protections. Indeed, Congress expressly recognized that speculators need relevant information in order to make intelligent investment decisions, as do more conservative investors.[14]

2. Although concededly petitioner did not have all the information available to the other defendants about the drilling results (see pp. 5–7, 9–11, *supra*), the court of appeals properly held that he should not have accepted stock options while this information was concealed from the directors.[15] Like the other recipients

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[14] Although one of the purposes of the Act was to curb *excessive* speculation, the House committee that reported out the bill that eventually became the Act stated that "[t]here is plenty of room for *legitimate* speculation in the balancing of investment demand and supply * * *"; it went on to recognize that "[n]o investor, no *speculator*, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 11 (emphasis added).

[15] In reviewing the decision of the district court, the court of appeals was not bound by the lower court's conclusions as to materiality. The evidentiary facts were basically undisputed, and the court of appeals accepted the findings of the district court in this regard. In both its main brief (pp. 4–5, 24, 27) and reply brief (pp. 1–2) in the court of appeals, the Commission relied solely upon the district court's evidentiary findings, the undisputed facts and the testimony of the defendants and their own experts with regard to the materiality of this drilling; it did not rely upon any testimony of its own experts. Copies of these briefs have been lodged in this Court.

of the stock options, petitioner was receiving a bonus from directors from whom important facts were concealed. His awareness of the concealment from the directors is a matter peculiarly within his own knowledge and, in the circumstances of this case, was properly presumed in the absence of his coming forward with proof that he was not aware of it. As secretary of the corporation, it was his duty to attend the board meetings and take notes of the proceedings (Pet. App. 192a), and he therefore must have known that the drilling had not been discussed there. Petitioner was called as a witness by the Commission and was cross-examined by his counsel. If he had been unaware of the concealment, he had every opportunity to say so. Any deficiency in the record in this regard (Pet. 9n., 22–23) is, therefore, chargeable to petitioner himself.[16]

This Court has repeatedly held that Rule 52(a) of the Federal Rules of Civil Procedure does not shield findings of fact based upon the application of erroneous legal standards to undisputed evidentiary facts. *E.g.*, *United States* v. *General Motors Corp.*, 384 U.S. 127, 142 n.16; *United States* v. *Parke, Davis & Co.*, 362 U.S. 29, 44. In any event, the ultimate question of materiality is one of law subject to review by the court of appeals. *E.g.*, *United States* v. *Bernard*, 384 F. 2d 915 (C.A. 2) (*per curiam*); *United States* v. *Ivey*, 322 F. 2d 523, 529 (C.A. 4), certiorari denied, 375 U.S. 953; *United States* v. *Parker*, 244 F. 2d 943, 950 (C.A. 7), certiorari denied, 355 U.S. 836.

[16] Petitioner's argument that he could not violate Section 10 (b) and Rule 10b–5 unless he actually knew that the drilling results were unavailable to the directors (Pet. 22) is also inconsistent with his own definition of *scienter* as including reason to know that they were uninformed (Pet. 23).

We recognize that the rather limited knowledge of the drilling results attributable to petitioner on the basis of this record makes it a close question whether petitioner's knowledge was material under the standard adopted by the court below. We believe, however, that the court was warranted in concluding that the test of materiality was met by the fact that the corporation's president and executive vice president considered the "favorable development" of the drilling results significant enough to discuss the news with petitioner and to tell him that they wanted to acquire the adjoining land (see pp. 6–7, *supra*). In any event, the question was fully considered by the court of appeals *en banc* (see Pet. App. 102a–103a, 146a), and there is no reason why this Court should review the correctness of that court's application of proper legal standards to these peculiar facts.[17]

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[17] Unlike some of the recipients of the stock options, petitioner was a member of the corporation's top management, was present at the meetings of the board of directors and its stock option committee, and was informed that the initial stage of a generally-concealed corporate development of great potential was favorable (see Statement, *supra*, pp. 6–8, 10). The court of appeals undoubtedly recognized that since the purpose of employee stock options is to encourage and reward effective performance on behalf of the corporation, the law—whether substantive or remedial—should not place a premium on lack of diligence by a member of top management in ascertaining whether corporate developments of which he has been informed are sufficiently favorable to require their disclosure to the directors because of their material bearing on the award of stock options.

3. As the court of appeals noted (see n. 7, *supra*), petitioner did not argue below that the appropriate time for disclosure to the directors was prior to exercise of the option rather than prior to its acceptance. In a somewhat indirect manner he does make that argument in this Court (Pet. 13, 25). While we do not believe that issue should now be decided by this Court since the court of appeals has left it open for future cases (see p. 12, *supra*), it is clear in any event that the time of acceptance of the option is the relevant time, for that is when the directors need the information in order to determine whether and on what terms to issue the options. This does not mean that the interests of the corporation need be compromised by premature disclosure of corporate secrets. If it is appropriate not to reveal those secrets to the directors, it should be sufficient for the management merely to recommend that the granting of stock options be postponed. As pointed out in the concurring opinion of Judge Friendly, nonmanagement directors would not ordinarily challenge such a recommendation from top management (Pet. App. 120a).[18]

Moreover, the stock option plan approved by the Texas Gulf shareholders required that the options be

[18] Judge Friendly also questioned the justification for management to erect a wall of secrecy between the directors, who are charged with the responsibility for managing the corporation, and important developments in its affairs (Pet. App. 120a).

exercisable at the "fair market value" of the underlying stock on the date they were granted, not some other date, and that their granting and exercise "be subject to all applicable laws, rules and regulations * * *" (P.X. 7). It is at least questionable whether this particular plan authorized the directors to ratify options the original issuance of which was defective because it involved a violation of the federal securities laws, and the exercise price of which was far below the fair market value on the date that this defect was attempted to be cured.[19]

If the appropriate time for disclosure, even when corporate secrecy is thought to be necessary, is the granting of the options, then subsequent action by the board of directors cannot cure a violation that has already occurred. Since this is an enforcement proceeding brought by the Commission, ratification can have no effect here, whatever its significance as between petitioner and Texas Gulf.

4. Relying on the Fifth Amendment, petitioner also complains that Rule 10b–5 is not sufficiently definite to have given him notice that his conduct was proscribed (Pet. 24).

In this area "[t]he test is whether the language conveys sufficiently definite warning as to the proscribed conduct when measured by common understanding and practices." *Jordan* v. *DeGeorge,* 341

[19] Although both courts below describe the resolution of July 15, 1965 as a "ratification", it is doubtful whether it rose to that level. (see pp. 8, 11, *supra*)

U.S. 223, 231–232; accord, *United States* v. *National Dairy Products Corp.*, 372 U.S. 29, 32; *McGowan* v. *Maryland*, 366 U.S. 420, 428; *Sproles* v. *Binford*, 286 U.S. 374, 393. See, also, *Securities and Exchange Commission* v. *Capital Gains Bureau*, 375 U.S. 180, 193, n. 41, 199.

There are, of course, some areas of the law in which it is not possible to anticipate all harmful conduct by specific rules. Prohibitions of fraud and deception fall within this category. Rule 10b–5 is, therefore, necessarily stated in rather broad terms, which absorb their meaning from the particular business context in which the deceptive practices occur. Cf. *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 202–203.[20]

5. Petitioner finally contends that the court of appeals' order of rescission, disregarding the order of the district court that there be a subsequent hearing on remedy in that court, deprived him of his right to be heard (Pet. 26). The court of appeals recognized that questions of remedy were generally to be deferred (Pet. App. 69a n.1), but apparently regarded the surrender of petitioner's option as the only appropriate remedy once it was determined that the option had been accepted in violation of the statute. Petitioner had the opportunity to urge in the petition for rehearing to that court that "rescission goes beyond statutory authority and the proper exercise of federal equity power" (Pet. 26), and, in fact, he did

[20]See, also, remarks of Judge Friendly in *Conference on Codification of the Federal Securities Laws*, 22 Bus. Lawyer 793, 900, 901 (1967).

so briefly.[21] As to that issue, this Court has previously upheld the power of the government to seek, and the courts to grant, restitution as an ancillary remedy in the exercise of the courts' general equity powers to afford complete relief. *Mitchell* v. *DeMario Jewelry,* 361 U.S. 288; *Porter* v. *Warner Holding Co.,* 328 U.S. 395; cf. *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 433–435. This remedy, which is necessary to deter future violations by removing any monetary incentive to risk injunctive relief, may be afforded to the government even though injunctive relief is neither sought nor granted. See *United States* v. *Moore,* 340 U.S. 616.[22]

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[21] See pages 26–27 of the petition for rehearing which has been lodged in this Court.

[22] Subsection (e) of Section 21 of the Act, 15 U.S.C. 78u, refers only to injunctive relief. Subsection (f), like the statutory provision involved in the *Moore* case, *supra*, gives the courts jurisdiction to grant "writs of mandamus commanding any person to comply with the provisions of this title * * *." Thus, *United States* v. *Parkinson*, 240 F. 2d 918 (C.A. 9), which involved a statute that authorized only injunctive relief, does not conflict with the decision below.

CONCLUSION

Despite the significance of the case out of which this petition for a writ of certiorari arises, the petition itself does not present any questions warranting review by the Court and should be denied.

Respectfully submitted.

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MARCH 1969.

U.S. GOVERNMENT PRINTING OFFICE: 1969

SUPREME COURT, U. S.

FILED
MAR 24 1969
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM 1968

No. 897

FRANCIS G. COATES,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

PETITIONER'S REPLY BRIEF

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Respondent.

PETITIONER'S REPLY BRIEF

I

In its Brief in Opposition to our Petition, the Commission erroneously suggests (pp. 2, 14) that the only question presented by our Petition is whether, *assuming* that Section 10(b) and the relevant subdivisions of Rule 10b-5* prohibit a corporate insider from trading on the basis of important information not available to the public, such prohibition continues after the information has been released at a press conference. The Commission's brief thus ignores the fact that our Petition directly challenges the validity of the Commission's basic assumption.

Although the Commission contends that Section 10(b) and Rule 10b-5 prohibit insiders from purchasing their corporation's securities on an exchange without disclosing material information to the sellers, it makes no effort to

*Only subdivisions 1 and 3 are relevant herein. *See* Petition, p. 11.

demonstrate by analysis how such conduct comes within the Rule's prohibition against fraud or deceit. Instead, it merely asserts that Rule 10b-5 contains such a prohibition (Brief in Opposition, pp. 11, 14, 21) and argues that such a prohibition is appropriate and consistent with statutory objectives (Brief in Opposition, pp. 12, 14-17). However, the question presented herein is not whether such a prohibition, affecting directorial conduct, may be desirable for the protection of the investing public. The question is whether such prohibition is contained in the Rule 10b-5 proscription against fraud or deceit.

Petitioner does not contend, as the Commission suggests (Brief in Opposition, pp. 19-20), that an insider is insulated from liability under Section 10(b) and Rule 10b-5 merely because his purchase or sale is executed on a securities exchange. Regardless of whether the transaction is executed on a securities exchange or conducted face-to-face the question is whether the circumstances of the transaction impose a duty of disclosure on the corporate insider so that a failure to disclose may constitute fraud or deceit. It is fundamental that mere nondisclosure is not fraud unless there is a duty to disclose. Contrary to the Commission's statements (Brief in Opposition, pp. 14, 21), prior to this action no Court has held an insider to have violated Section 10(b) or subdivisions (1) or (3) of Rule 10b-5 for failing to disclose material information to those from whom he purchased his corporation's securities unless there were special facts which created a duty of disclosure.*

*The cases cited by the Commission (Brief in Opposition, p. 21, fn. 22) involved alleged schemes by insiders to induce minority shareholders to sell their stock by (1) reducing the dividend in order to depress the market value of the stock and concealing the identity of the buyer, (2) making untrue statements and failing to state facts necessary in order to make statements made not misleading or (3) concealing facts, including the identity of the buyer, in negotiated transactions under circumstances which entitled the seller to expect a statement of all material facts.

This Court's opinion in *Strong* v. *Repide*, 213 U. S. 419 (1909), makes clear that the materiality of information is not in itself a "special fact" creating such a duty and petitioner's acts did not involve any of the facts and relationships which heretofore have been or could be held to create a duty to disclose. Therefore, petitioner was not under a duty to disclose inside information at the time he placed his order, sellers did not expect any disclosures from him and his failure to make disclosures could not constitute fraud or deceit.

II

The Commission argues that a director's purchase of stock on the basis of inside information constitutes fraud or deceit even if he honestly believed the information to be available to the public (Brief in Opposition, pp. 17-19). In so arguing, the Commission relies on this Court's opinion in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180 (1963). However, in that action this Court, although holding that "intent to defraud" did not have to be established because of the nature of the proceeding before it,* did not hold that negligence may be equated with fraud even in that context and expressly found the entirely separate element of "scienter" to be present. Moreover, it is significant to note that *Capital Gains* came before this Court on a denial of the Commission's application for a preliminary injunction to prevent the adviser from defrauding his

*An injunctive action against a registered investment adviser under the Investment Advisers Act which reflects:

> ". . . a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser —consciously or unconsciously—to render advice which was not disinterested." (375 U. S. at 191, 192).

clients. By contrast, in this proceeding, the Commission is not attempting to protect the investing public from future conduct by petitioner, rather, it is seeking to punish him for allegedly committing fraud in 1964.* Where, as here, the Commission is seeking to punish an alleged wrongdoer its burden is and should be greater than if it were merely seeking to protect the public from future frauds through the "mild prophylactic" of disclosure.

Thus, even if one were to assume the existence of a duty to disclose, petitioner's honest belief that the news had been disseminated would preclude a finding of fraud or deceit. Petitioner does not argue, as the Commission erroneously suggests, that his purchases were not fraudulent because he made a mistake of law, *i.e.*, that he was not "aware of the duty" of disclosure (Brief in Opposition, pp. 11-12). Petitioner's position is that he honestly believed that the news had been disseminated, a position sustained by the court below (App. A, 3619, 3621).** Petitioner, therefore, cannot be held to have committed fraud or deceit.

---

*The Commission stated to the District Court in its opening statement that:

> "The Commission's objective in bringing these proceedings before the Court are to drag to light and pillory the misconduct of the individual defendants in these proceedings." (Joint Appendix in the Court of Appeals, p. 283a).

**Petitioner did not place his order "at the very moment that dramatic news . . . [was] handed out to the news media" as the Commission suggests (Brief in Opposition, p. 14) but only after he believed that the news would be on the broad tape. The reasonableness of petitioner's belief that the news would be on the broad tape within minutes after reporters left the press conference is confirmed by the Dow Jones reporter (R. 2453-54) and by the Commission which concedes that:

> "The first section would normally have appeared on the broad tape within two or three minutes after the reporter had dictated it." (Brief in Opposition, p. 9, fn. 3).

III

The Commission makes no effort to demonstrate, and cannot demonstrate, that Section 10(b) and Rule 10b-5 give notice that they apply to conduct untainted by fraud and prohibit purchases by a director even after corporate information has been publicly announced. Indeed, the Commission concedes the vagueness of Rule 10b-5 asserting that it is stated "in rather broad terms which absorb their meaning from the particular business context in which the deceptive practices occur" (Brief in Opposition, p. 24). It is clear, therefore, that Section 10(b) and Rule 10b-5 as now construed by the Commisison and the Court below lack the ascertainable standard of conduct required by the United States Constitution.

IV

The questions presented herein are of great importance to all corporate officers and directors and to the investing public and, as this Court recently noted, arise "in an area where glib generalizations and unthinking abstractions are major occupational hazards." *SEC* v. *National Securities, Inc.*, 89 S. Ct. 564, 571 (1969).

Although the Commission concedes the "significance of the case out of which this petition for a writ of certiorari arises" it seeks to avoid review of the questions presented herein on the ground that the questions are narrow ones of limited interest (Brief in Opposition, pp. 14, 17, 25). That assertion is without basis in fact.* Petitioner is the only remaining defendant in the *Texas Gulf* case who was

*The New York Stock Exchange in a policy statement adopted long after petitioner's purchases, advises that corporate officials should wait until after the release of important developments has appeared in the press before making a purchase or sale. However, that is merely a suggested rule of thumb and not a "requirement"

charged with purchasing Texas Gulf stock after the conclusion of the company's April 16 press conference and only his petition can present all of the fundamental questions raised herein. In addition, a related petition, *i.e., Kline* v. *SEC* (No. 937), is also pending before this Court. The two petitions present virtually the full spectrum of questions presented by the Commission's charges against the individual defendants in *SEC v. Texas Gulf Sulphur.*

The Commission is incorrect when it asserts that this petition does not "raise either the question whether some further dissemination than appearance on the Dow Jones broad tape is necessary, or whether a waiting period after dissemination is necessary in order to give the public an opportunity to evaluate the news" (Brief in Opposition, p. 17). The Court of Appeals held that petitioner's violations encompass not only his purchases but purchases by his son-in-law and customers of his son-in-law (App. A, 3622 fn. 23). Many of those purchases were made hours after the news had appeared on the broad tape (Joint Appendix in the Court of Appeals, p. 238a).

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binding on insiders of corporations listed on that Exchange as the Commission argues (Brief in Opposition, p. 17), New York Stock Exchange, *Company Manual,* A-24 to A-27 (July 18, 1968). The New York Stock Exchange states that "the final decision of each officer and director with respect to securities transactions must be his own" (A-26, A-27). The new New York Stock Exchange guideline in no way diminishes the vast importance of the issues presented herein. Moreover, as of January 31, 1969, 1,273 corporations were listed on the New York Stock Exchange compared with the more than 950 corporations whose shares are listed on the American Stock Exchange and more than 18,000 corporations whose shares are traded in the over-the-counter market. See News Release, New York Stock Exchange News Bureau, Feb. 5, 1969; American Stock Exchange, *Stocks on the Amex,* Mid-1968 Ed.; The National Quotation Bureau, *The National Monthly Stock Summary,* Jan. 1, 1969.

It is significant that the statement of the New York Stock Exchange promulgated long after petitioner's purchases is the only guideline cited by the Commission which suggests a waiting period after corporate announcements.

This petition squarely raises basic questions as to the scope, meaning and constitutionality of "one of the most important and elusive" and likely "the most litigated" provision in the federal securities laws, *SEC* v. *National Securities Inc., supra,* 89 S. Ct. at 571, 574. Those questions have not been and should be decided by this Court.

CONCLUSION

For the foregoing reasons, and the reasons set forth in the petition, this petition for a writ of certiorari should be granted.

March 21, 1969

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APR 2 1969
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1968

No. 937

HAROLD B. KLINE,

Petitioner,

against

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

Introductory Statement

The Commission has acknowledged the significance of the case from which this petition arises, but would avoid review by claiming that the issues relating to petitioner are narrow. This is not so. The questions raised by this petition and the Coates petition (No. 897) lie at the heart of Rule 10b-5 and they cover substantially all the legal issues relating to the conduct of corporate personnel with respect to purchases of their company's stock, receipt of stock op-

tions, and divulgence of information. In addition, the petitions in *Weitzen* v. *Heit* (No. 893) and *Great American Industries Inc.* v. *Securities and Exchange Commission* (No. 1195) although they involve different facts, present legal questions similar to those involved in the Commission's charge against Texas Gulf Sulphur Company now pending before the District Court.

The inconsistent positions taken by the Commission at various stages of this lawsuit and enunciated at various points in the opinion of the Court of Appeals have generated massive confusion. Resolution by this Court of the questions presented will provide guidance for the public and ameliorate the confusion and concern now prevalent in the business and financial community.

The holding of the Court of Appeals that petitioner violated Section 10(b) of the Securities Exchange Act required first a finding that the complete and detailed results of an initial exploratory drill hole were "material"; second, that petitioner's limited knowledge was itself sufficient to comprise knowledge of material facts; and third, in a case of first impression, the creation of a legal principle that petitioner's failure to volunteer his limited information to a committee which awarded him stock options constituted a manipulative or deceptive device or contrivance under Section 10(b) and fraud and deceit under Rule 10b-5.

The question of whether the basic, detailed facts were themselves material* involves the fixing of a standard of

* This question is of course applicable to all of the defendants in this case who purchased Texas Gulf stock on a stock exchange prior to April 15, 1964, even though they are not at this time petitioning the court. The basic legal issue as to whether purchases with undisclosed information violate Section 10(b) and Rule 10b-5 is directly involved in the Coates petition (No. 897).

materiality with the widest application and interest. A determination concerning the degree of knowledge necessary for a finding that a person possesses material information has, with all its possible applications, even wider scope. Further, the use of a rule prohibiting "fraud and deceit" to establish doctrines of intra-corporate responsibilities which go far beyond securities regulation is a development which should receive close scrutiny by this Court.

In its opposing brief, respondent asserts, as it did in opposing the Coates petition, that Texas Gulf has announced that it intends to petition for certiorari in due course, citing CCH Fed. Sec. L. Rep. ¶77,589 (Aug. 15, 1968). This is incorrect; Texas Gulf has never made such an announcement.* In any event, review should not be denied because of a remote possibility that a completely separate aspect of this case might, at some later date, reach this Court.

I

The Standard of Materiality and Its Application

In determining what facts constitute "material" information, "the Texas Gulf Sulphur decision of the Second Circuit has contributed confusion rather than clarity." Bromberg, *Financial Analysts Journal* 30 (March-April,

* The announcement cited by the Commission stated that the *individual* defendants would petition for certiorari in due course. To this day there has been no finding of violation of Section 10(b) and Rule 10b-5 by Texas Gulf Sulphur Company and, as the opinions below indicate, it is unlikely that an injunction will ultimately be ordered following further hearing in the District Court. Any future petition for certiorari by the Company is thus purely speculative.

1969). This confusion continues. See, e.g. *Wall Street Journal,* March 19, 1969, p. 18, col. 2.

It is significant that in its attempts to justify the decision of the Court of Appeals, respondent nowhere attempts to reconcile that decision with "the average, prudent investor" test,* heretofore considered fundamental as the standard for determining materiality under the securities laws (Pet. pp. 15-19), and indeed at one time, prior to trial, urged by the Commission in this litigation (R. 4621, n. 10). The incompatibility of that standard with the decision of the Second Circuit has caused great confusion and serious concern.

If permitted to stand, the decision of the Court of Appeals could mean that a registration statement, drafted in full compliance with the 1933 Act and the standards of materiality thereunder, would be the subject of a suit by a seller under Rule 10b-5 for failure to disclose a fact which "may" affect speculative desires. In such a situation, the specific disclosure requirements of the 1933 Act would serve only to entrap those who comply with their terms.

While it is true, as respondents assert, that the Court of Appeals *stated* two common tests of materiality previously enunciated by the courts, it also stated several other tests, as pointed out in the Petition (pp. 11, 15-19). These tests range from a description of material facts as those which are "essentially extraordinary", and reasonably certain to have a "substantial effect" on the market, to

* The Court of Appeals explicitly rejected assessing materiality from the view of the "prudent" investor (87a); furthermore, the "speculators and chartists of Wall and Bay Streets" on whose views the court relied (87a, 90a) are hardly "average".

"those facts which may affect the desire of investors [defined to include "the speculators and chartists of Wall and Bay Streets"] to buy, sell or hold". It is this last test which was apparently *applied* by the Court of Appeals. Professor Bromberg, *supra,* points out "the two sets of ideas are inconsistent, and we will be plagued by doubts as a result. The net effect of the court's opinion is * * * to set a very low threshold of materiality", one which he finds "dangerously low from the viewpoint of persons who honestly want to know if they have information which imposes legal restrictions on them".

That there is uncertainty as to the applicable standard of materiality is highlighted by the fact that the Commission itself has been unable to maintain a consistent position as to materiality in this litigation. In its pre-trial memorandum of law (R. 4621) respondent claimed that the initial drilling results "bore a clear relationship to the intrinsic value of the company's stock". Alternatively, it relied on the "average prudent investor" test and stated further that the standard of materiality must be objective rather than subjective (R. 4621, n. 10).

In its post-trial brief, the Commission abandoned the intrinsic value formulation of the test of materiality and the argument that the test must be objective; and these contentions have nowhere appeared again. In that brief, the Commission urged that material facts are those of which a "reasonable, prudent investor" would wish to be informed, or which could "reasonably be anticipated to have a significant impact upon the market for the security involved" (R. 5202). These standards were adopted by the District

Court* (25a, 26a, 30a, 33a), and it is upon the basis of these standards, as applied to factual findings which are not questioned by the Commission (Res. Br., p. 16, n. 15), that judgment for defendants was entered in the District Court.

In its brief as plaintiff-appellant before the Second Circuit (p. 30), respondent for the first time urged that materiality should be judged from the viewpoint of a short-term speculator.** Nowhere did respondent advert to the "average prudent investor" test (which hardly includes chartists or Bay Street speculators), upon which it had relied previously. It also stressed a subjective test of materiality based upon the importance allegedly attached to the information by the insiders,† ignoring its previous argument in favor of an objective test.

Thus the Commission departed from its own published and previously advocated standards and urged several different tests of materiality in this case. These shifting

* It is not correct to assert, as respondents do, that the District Court considered materiality from the point of view of the "long-term, conservative investor" (Res. Br., p. 9). These words nowhere appear in that court's opinion; what the District Court noted, in accordance with the "average, prudent investor" test, is that "information is not material merely because it would be of interest to the speculator on Bay Street or Wall Street" (25a). Judge Bonsal held that "The results of K-55-1 were too 'remote' when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, i.e., to be deemed material" (30a).

** Respondent has lodged its briefs before the Court of Appeals with this Court. Similarly, petitioner will lodge defendants' briefs filed in the Court of Appeals with the Clerk of this Court.

† If applied to petitioner, this test leads to the conclusion that he did not know material information, for he bought no Texas Gulf stock.

standards, altered from time to time to suit the exigencies of litigation, no doubt contributed to the confusing decision of the Second Circuit with its varying statements as to the proper measure of materiality.*

II

The Evidence Relative to Petitioner

If the language of the Second Circuit affords little guidance as to what test was being applied by that court, the finding that the facts known to petitioner** constituted material information dramatically illustrates the low standard of materiality which was actually adopted.

Indeed, respondent goes so far as to concede that it is a "close question" whether petitioner's knowledge was material. Yet it contends that the conclusion of the court below was warranted by the fact that the company's president and executive vice-president considered the "favorable development" of the drilling results significant enough to discuss the news with him and to tell him they wanted to acquire the adjoining land (Res. Br., p. 18). This is a step beyond respondent's argument, adopted by the Court of Appeals, that purchases of stock by corporate officers and employees is the best evidence of the materiality of information known to them. Under the Commission's ra-

* Similar vacillations of respondent as to the time insiders may properly invest following public disclosure are detailed in the Coates' petition, pp. 23-25.

** It should be noted that the facts stated in respondent's brief under the heading "The Evidence Relevant to Petitioner", pp. 4-6, were in fact not known to petitioner. And contrary to the insinuation in the Commission's brief (p. 18, n. 17), petitioner was not told that there had been a "corporate development of great potential".

tionale, all information imparted becomes material because it is imparted. "The act it seems, outlaws itself." Note, 82 Harv. L. Rev. 938, 944 (1968). Such reasoning would make "material" luncheon conversation that the company was considering a new style letterhead. This far-fetched attempt to justify the Court of Appeals' holding as to petitioner is final proof, if proof is needed, that the court below erred.

Thus the issue which the Commission claims to be central here does not fit the facts. Even if the Commission's legal theory is accepted, the question presented is not whether a corporate official, accepting options, is required to disclose information that "might be expected substantially to affect the value of the corporation's stock" (Res. Br., p. 2). Instead the question would be whether a corporate official can be deemed to have "material" information about a corporate project when he has been told of a favorable initial development but does not know enough to gauge its importance.

III

Due Process

Respondent asserts that the Fifth Amendment is satisfied if statutory or regulatory language conveys sufficiently definite warning as to proscribed conduct when measured by "common understanding and practices." (Res. Br., p. 20). Had Section 10(b) and Rule 10b-5 given such warning* the case would not have received the vast publicity

* It has become apparent that the SEC itself argues and promotes this vagueness, believing that vagueness in itself has a deterrent effect. Note, 82 Harv. L. Rev. 938, 945 (1969). Vagueness as a deterrent is a concept completely incompatible with the Constitution of the United States. Its use, apparently as a matter of policy by a federal agency, should not be countenanced.

and caused the concern that it has. Indeed, as we have seen above, the Commission, notwithstanding its expertise in this area, has been unable or unwilling to formulate or apply clear standards which would have given such warning.

How the duty of disclosure imposed upon petitioner could be derived from the statute and rule is utterly inexplicable. The duty is based on the assertions that petitioner was a member of "top management" and was relied upon by the Board of Directors and the Stock Option Committee in granting options. The first assertion has no record support, and indeed is directly contrary to the finding of the District Court that petitioner was not a member of top management (47a). The second assertion is likewise contrary to the factual record: The evidence at the trial was that the Board and the Stock Option Committee actually relied for recommendations on Texas Gulf's president and executive vice-president, not on petitioner, in granting options (179a).* Respondent's contention, we submit, is without support in general corporate law, is contrary to the facts, and is far removed from concepts of fraud and deceit.

Similarly, respondent argues that petitioner was correctly found to have violated Rule 10b-5 because he allegedly lacked diligence "in ascertaining whether corporate de-

* Petitioner was Secretary of the Company and acted as such at the meetings on February 20, 1964 of the Board of Directors and Stock Option Committee (192a). "The secretary of a corporation is not an executive officer. * * * He's merely a ministerial officer, who keeps the books and minutes of the stockholders' and directors' meetings and has charge of the corporate seal." Prentice-Hall, Corporation ¶1715.

velopments of which he has been informed [admittedly in only the most general way] are sufficiently favorable to require their disclosure to the directors because of their material bearing on the award of stock options'' (Res. Br., p. 18, n. 17). Translated, this means that a stock option recipient must search his mind for all fragments of information known to him which might conceivably relate to important corporate developments, and then investigate to determine whether each such development is in fact important, before he may safely accept options. Rule 10b-5 gave no warning that such a far-reaching duty had been imposed upon petitioner, nor could any reasonable man infer the existence of such a duty from the language of Section 10(b) prohibiting ''any manipulative or deceptive device or contrivance, as the Commission may prescribe.''

I V

Remedy

Respondent has wholly failed to meet the contention that petitioner was deprived of his right to be heard upon the question of remedy in this case. While petitioner did in fact urge in his petition for rehearing before the Court of Appeals that the order for rescission went beyond statutory authority, that petition was denied. Thus, he has never received a hearing at the appellate level, much less in the District Court where evidence could have been presented, as to the necessity for such drastic relief.

Finally, respondent urges that the order of rescission was proper as an ''ancillary'' remedy. However, no in-

junction order has been issued, and there is no authorization for "other orders" under Section 21(e) of the 1934 Act, comparable to that relied on in *United States* v. *Moore,* 340 U.S. 616 (1951). Respondent's reference to Section 21(f) of the 1934 Act, which authorizes writs of mandamus, is spurious, for petitioner is not a person who has specified duties under the 1934 Act and who is thus subject to mandamus if he fails to perform them.

Conclusion

This petition presents basic legal questions of first impression which are of great public importance. In addition, the reputation of a man of excellent character and standing in the community has been seriously and unfairly injured. The charge against this petitioner is that he violated a statute and rule dealing with "manipulative and deceptive devices". As Professor Loss says,

> "In effect, the charge of deceit * * * is an accusation of thievery." 3 Loss, Securities Regulation 1432 (2d Ed. 1961)

The avowed purpose of the Commission in bringing this action was to "drag to light and pillory" petitioner and other defendants (R. 17). The penalties and ignominy attached to a finding of fraud should not be imposed without ample evidence to support it. Here there was none.

For the foregoing reasons, and the reasons set forth in the petition, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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April 1, 1969